DUFF & PHELPS

EYE ON THE MARKETS

OUR GLOBAL NEWSLETTER FOCUSING ON REGULATION FOR TRADING MARKETS

Summer 2016

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MIFID II TRANSACTION REPORTING: THERE'S NO TIME FOR COMPLACENCY

MAR: DOING NOTHING IS NO LONGER AN OPTION FOR BUY-SIDE FIRMS

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Monique Melis

WELCOME

Welcome to Duff & Phelps' third edition of *Eye on the Markets*, our newsletter focusing on regulation for trading markets. Since our last edition, the global team has expanded through the acquisition of Counselworks, a leading provider of compliance and regulatory advisory services in the U.S. which is now part of the Duff & Phelps' Compliance and Regulatory Consulting Practice.

The global regulatory landscape continues to develop rapidly, with a focus among policy-makers and regulators on finishing the implementation of the post-crisis legislation and also on thinking about how regulation should evolve to meet the challenges of the next five to ten years. We are working with regulators, the firms they regulate, industry bodies, and information and technology providers around the globe and see similar trends in the evolution of markets regulation across all leading financial centres.

The uncertainty around the MiFID II deadline is seemingly being resolved and the now very imminent Market Abuse Regulation (MAR) is starting to bite. It is clear that there will be more compliance work for the buy-side as a result of these new pieces of European legislation. Monitoring for market abuse can no longer be seen as an obligation that falls on the sell-side, whilst their buy-side counterparts can manage with a far lighter monitoring regime.

Moreover, all major regulators seem to be struggling with 'enforcing personal accountability'. The Senior Managers Regime (SMR) directly replaced the Approved Persons Regime for the largest firms in the UK earlier this year, with plans to roll the new regime out to all regulated firms in 2018. The effects of the new regime are already being seen, as the nature of corporate governance and the approach to risk taken by senior managers change. The FCA has published guidance on how the SMR will be enforced in practice, showing that they expect it to be fully adopted and embraced by the industry.

We are undertaking our annual analysis of global enforcement trends at present. Some interesting themes are emerging and we will issue our Global Enforcement Review 2016 report in July, which will be followed up by events in London, New York and Hong Kong.

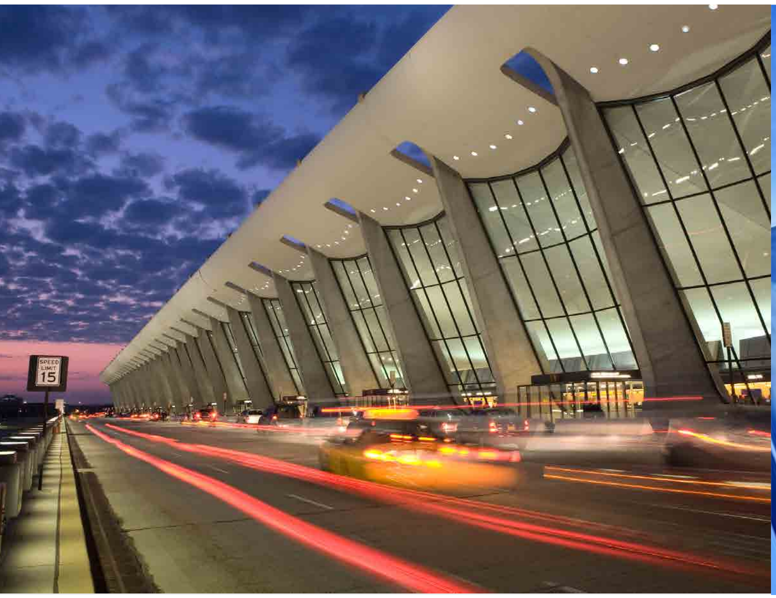
Finally, I would like to say a warm welcome to Nick Bayley whom I have known for many years, since his time as Head of Regulation at the LSE. Nick joined our London team in February from the FCA where he worked both in Enforcement and, most recently, as the Head of Department overseeing the FCA's work on MiFID II. Nick is a great addition to the ever expanding Markets team within our Regulatory Consulting practice and we will continue to do important and interesting work with our clients in this area over the coming months.

As always, we hope that you are able to take away some valuable insights from the articles and look forward to any feedback you may have.

With kind regards,

Monique Melis
Managing Director and Global Head of Regulatory Consulting

Nick Bayley



MIFID II: IS THE DELAY GOING TO BE LONG ENOUGH?

On February 10, 2016, the European Commission proposed to delay the entry into application of MiFID II and MiFIR until January 3, 2018.

The Commission's justification was the scale of the challenge faced by the European Securities and Markets Authority (ESMA), national competent authorities (NCAs) and stakeholders in having essential data infrastructures in place for January 3, 2017.

Some EU politicians appear to hold the view that, despite the short time frame, financial services firms should 'just get on with it'. Moreover, it is politically difficult for the Commission to be seen to bow to pressure from industry for a delay.

In late April 2016, it was announced that the Financial Conduct Authority (FCA) has selected a new supplier to replace its current Zen transaction reporting system.

However, a delay is less objectionable if it is linked to ESMA and NCAs not being ready, as now seems to be the case.

Will January 2018 be Long Enough for Firms to Prepare Properly?

In late April 2016, it was announced that the FCA has selected a new supplier to replace its current Zen transaction reporting system. Like many other NCAs, the FCA has a dependency for instrument reference data on the ESMA project, and according to ESMA that system will *"not be operational before the third quarter of 2017"*[1]. The challenge of having FIRDS ready had been specifically cited by the European Commission as one of the reasons for delaying MiFID II.

Should we be Worried?

Some questions spring to mind:

- The FCA decided in April 2016 who will build its new MiFIR transaction reporting system - but when will that system be sufficiently developed to provide the technical specifications that firms and Approved Reporting Mechanisms (ARMs) need to develop for their own systems?
- Will the relatively late availability of ESMA's FIRDS system affect the timetable for FCA readiness and related industry testing?
- Given the scale of the challenges faced by ESMA and the NCAs, as well as their fairly patchy track record in the provision of complex IT systems, how confident can industry be that January 2018 is a realistic deadline?

In the past, regulators have generally not been defined by the quality of their technology and their ability to manage data but MiFID II may begin to change this perception. The importance of firms gathering and collating the right data for monitoring and compliance, reporting to clients or provision to the regulator is a key theme running through MiFID II. Regulation comes at a very considerable cost for firms and in return, the industry can legitimately expect the regulators to make good use of those data.

Of course, there are many other changes in MiFID II that also represent significant challenges, for example for firms that operate as Systematic Internalisers or trading venues, particularly the new Organised Trading Facilities (OTFs). Transaction reporting is far from being the only MiFID II change which is complex and has a long lead time but it is the one that probably has the greatest effect on the largest number of firms.

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[1]ESMA note of October 2, 2015

Nick Bayley

THE EUROPEAN CAPITAL MARKETS UNION

Regulation develops in cycles; regulation, deregulation, re-regulation... The cycles vary in length and depth but they will always occur.

Eight years on from the height of the financial crisis and policy-makers' thoughts have turned in a new direction. Rather than focus on making markets and firms safer, regulators need to manage the next wave of regulatory change in a way to support economic growth and job creation.

It could seem contradictory to suggest that yet more regulation might be capable of facilitating innovation and supporting economic growth but that is what is being talked about in Europe. The European Commission's next wave of regulation, a broad collection of 33 measures under the umbrella title of Capital Markets Union (CMU) specifically target 'jobs and growth' as the desired outcomes.

What's Most Eye-catching in the CMU?

High on the list is probably the plan to revitalise the moribund securitisation market. Securitisation, in whatever form, has a bad reputation, having been at the heart of the financial crisis. However, increased capital requirements in recent years have reinforced securitisation's value in freeing up banks' balance sheets to enable more lending to the real economy. In December 2015, the European Commission published a draft regulation on simple, transparent and standardised (STS) securitisation. It acknowledges the importance of a well-functioning securitisation market whilst noting that the problem caused by residential mortgage-backed securities (RMBS) during the crisis was largely a US rather than European one.

"For BBB-rated products US RMBS' default rates peaked at 62% and 46% (subprime and prime, respectively) while EU products' default rates peaked at 0.2%."

Another interesting measure in the CMU is the proposed *"review of EU corporate bond markets, focusing on how market liquidity can be improved"*. This is inextricably linked to the forthcoming MiFID II rules which will bring full pre- and post-trade transparency to more liquid corporate bonds. A measure that some believe could damage the already fragile levels of liquidity in these instruments.

Finally, the European Commission has undertaken a call for evidence on the cumulative impact of financial reform.

> Some market participants would probably like the Commission to halt any new legislation whilst the implementation of the new rules is completed (most notably MiFID II), so that the cumulative impact of the legislation can be assessed properly.

This has attracted many responses, pointing out potential overlaps, underlaps and mismatches in EU financial services legislation, with many highlighting the current fragmented EU approach to regulatory reporting as ripe for reform. Some market participants would probably like the Commission to halt any new legislation whilst the implementation of the new rules is completed (most notably MiFID II), so that the cumulative impact of the legislation can be assessed properly. However, Lord Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, and his team will be pressing on with the Benchmark Regulation, the Securities Financing Transactions Regulation, the Prospectus Regulation and the rest. Can you really regulate for 'jobs and growth'? Only time will tell.

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MIFID II TRANSACTION REPORTING: THERE'S NO TIME FOR COMPLACENCY

Many investment firms breathed a sigh of relief when the European Commission agreed to delay the implementation date for MiFID II by one year to January 2018.

An extra 12 months would ordinarily seem quite generous and more than sufficient time to implement regulatory changes but with the complexities and breadth of changes attributed to MiFID II, there is no time for complacency. Not least, as the legislation relating to post-trade transaction reporting is contained within the Regulation as opposed to a Directive. This means that EU member states must implement the rules as they are written and there is no scope for interpretation at national level. Unlike with MiFID I, this has been purposely orchestrated to ensure that there will be common and consistent standards of reporting applied across all EU countries.

The post-trade transaction reporting regime is being expanded significantly and the technical and operational challenges should not be underestimated. The number of fields associated with a transaction report increases from 24 under MiFID I to 65 fields under MiFID II. 48 out of the 65 fields are new and the remaining ones still require significant changes.

One of the main headaches for firms relates to reference data due to the sheer volumes and assortment of data. It includes product, instrument, trading venue, counterparty and client data. It requires firms to establish and integrate feeds from internal and external data sources in order to consume, for example, employee records, LEI, ISIN, CFI, and MIC related data required in transaction reports.

The key operational aspects to consider in this regard are:

- Reviewingofthereferentialdatagap to meet reporting requirements
- Mappingtheexpandedproductset and transaction types to the reporting framework
- Reviewingyourclienton-boarding process to capture information to meet the reporting requirements
- ContinuingtoreportunderMiFIDI whilst developing and running parallel test environments under MiFID II - all of which will be very costly to firms and have a significant drain on resources.

According to data service provider Avox, there are approximately 1.7 million active entities worldwide and all will require a Legal Entity Identifier code to trade with an investment firm under MiFID II. Approximately 400,000 LEI codes have been issued to date and therefore, over three quarters of entities do not yet have LEI codes. This underscores the challenge the financial services industry faces to be ready for the MiFID II implementation date.

Firms that haven't yet fully considered MiFID II are strongly encouraged to review their existing architecture in earnest in order to develop robust operational processes, systems and controls in time for January 2018.

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MAR: DOING NOTHING IS NO LONGER AN OPTION FOR BUY-SIDE FIRMS

With the go-live of the Market Abuse Regulation (MAR) looming, buy-side firms in particular should be aware of regulatory expectations, particularly in the realms of post-trade surveillance to detect insider dealing and market manipulation.

Some buy-side firms, especially the smaller ones, have tended to take the stance that they don't have the same level of responsibility as sell-side firms when it comes to preventing and detecting market abuse. However, this is not how the regulators see it. In the recently published MAR Level 3 Q&A (May 30, 2016) there is no room for misunderstanding amongst the buy-side firms on whether their activities are fully covered by MAR. ESMA said it "*considers that the obligation to detect and identify market abuse or attempted market abuse under Article 16(2) of MAR applies broadly, and 'persons professionally arranging or executing transactions' thus includes buy-side firms, such as investment management firms (AIFs and UCITS managers).*"

Suspicious Transaction Reports (soon to include orders) from the market are usually the best source of quality cases for the regulator. Market participants who have the closest relationship with the clients and the fullest understanding of the trading strategies are almost inevitably in the best position to detect potential abusive or manipulative behaviour. Training of front office staff on how to identify and escalate potential market abuse is therefore a crucial component of market abuse controls.

The High Court Judgment and £7m fine secured by the FCA in August 2015 against an asset manager and three individuals is a classic example of how buy-side firms could be susceptible to market abuse. The defendants accessed trading platforms via their brokers' DMA services to conduct abusive 'layering', by placing and cancelling large CFD orders to stimulate price movement of relevant shares. The judge found that the asset manager *"wholly failed to take any adequate steps to ensure that market abuse was not being committed... [and] was reckless in that regard."*

> The key message is that by July, buy-side firms must be able to demonstrate they are recording and analysing all their trading activity.

Further, the FCA's thematic review last year on asset managers and market abuse (TR15/1) showed that only two firms in their sample *"demonstrated post-trade surveillance that effectively highlighted and properly investigated potentially suspicious trades"*. These results should act as a wake-up call to firms because whilst we've seen some of our clients taking the initiative and putting some automated surveillance in place, many smaller asset managers and hedge funds still consider themselves largely untouched by the new rules.

Buy-side firms have been wary of having to invest large sums into the sort of complex automated surveillance systems that the trading platforms and sell-side rely on. This is a quite understandable stance since such expensive and powerful systems may not be a proportionate solution given the firm's business model.

With MAR coming into force, the key message is that by July, buy-side firms must be able to demonstrate they are recording and analysing all of their trading activity and conducting surveillance to detect not only suspicious transactions but also suspicious orders. MiFID II implementation in January 2018 will extend the MAR's scope to more markets and trading platforms, which means that more fixed income and derivative products will be caught by the need to have adequate surveillance.

So what does 'acceptable' look like for the buy-side? The answer is that firms need to demonstrate they have identified and assessed all inherent market abuse risks across all trading desks and asset classes. They need to be aware of the breadth of market abuse risks; that insider dealing can be committed using non-equity instruments, how employees could front run orders through personal account dealing (PAD), how bond prices can be ramped manipulatively and that fictitious orders could be submitted to their brokers or via DMA. Firms then need to implement an adequate level of surveillance, particularly in the second line of defence, to detect such behaviours.

Whilst there is still a role for comprehensive, well thought-out manual monitoring in smaller firms, investment in flexible automated surveillance tools could transform the quality of a firm's surveillance. Such systems (which can detect potential instances of insider dealing, layering and spoofing, increased market participation and wash trading) coupled with PAD monitoring and, depending on how trading is conducted, risk based surveillance of emails and Bloomberg chats, are available from a wider range of vendors than ever before.

Judgment is needed in deciding what level of automated surveillance is required and which are likely to be the most cost-effective solutions. However, what is clear is that doing nothing is no longer an option.

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Alexandra Dobra

INFORMAL BUSINESS CULTURE IN FINANCIAL SERVICES: DOES IT MATTER?

By Alexandra Dobra, Doctoral Candidate in Behavioural Finance at the University of Warwick and External Consultant

The State of Play

2015 was, again, a year of "first time cases" for enforcement actions with total fines amounting £6.2b across the FCA, CFTC, FINRA, SEC and SEC. Despite that enforcement actions further add to the cost pressures of financial services companies, they do not seem to be enough of a deterrent for avoiding non-compliant behaviours.

Meanwhile, to identify and prevent non-compliant behaviours, financial services companies continue to invest in data analytics-driven compliance and risk frameworks. In addition, firms continue to implement business culture change programmes, as the role they play in non-compliant behaviours has been widely acknowledged, especially following the Saltz Review in 2013. However, critics argue that business culture transformation programmes are mere window-dressing techniques.

Whilst these above-mentioned actions are necessary, they fail to act upon one of the industry's invisible challenges, namely informal business culture. As a consequence, compliance and risk frameworks, alongside business culture transformation programmes, will continue to be sub-optimal if they are overshadowed by strong formal-informal business culture asymmetries.

Informal Business Culture: Why it Matters?

Informal business culture is the set of organisational characteristics and relationships that are hidden but powerful as they informally reinforce certain values and behaviours. When the asymmetry between the formal and informal business culture is strong, agents tend to revert to the informal business culture for informing their behaviours.

Informal business culture can contribute to nurturing behavioural biases. For example, if the informal business culture over-emphasises top performance, agents will face self-worth stresses that lead to rationalisation, self-serving behaviours, alongside other biases. Ultimately, these biases will be driving the agent away from cultivating one of the key factors for avoiding non-compliant behaviour, namely critical judgement.

Informal business culture and subsequent behavioural biases can also contribute to nurturing unintended behavioural consequences. Partly the reason why compliance and risk frameworks are not working is because they are distorting the decision-making process. Therefore, behaviours intended to outsmart the system are encouraged. In addition, compliance and risk frameworks can also create a perception of safe-harbour whereby agents tend to shift their responsibility, with regard to compliant behaviour, by thinking that "it is someone else's job".

Informal Business Culture: How to Fix It?

To achieve a sustainable change in business culture, the formal-informal business culture asymmetry must be tackled. For this purpose, in broad brush, a three stage plan is necessary:

1. DiagnosticStage:(i)developandupdate, through machine-learning algorithms, an informal business culture database and (ii) develop a formal-informal business culture asymmetry map.

2. Awareness Stage: (i) communicate the features of the informal business culture and (ii) raise awareness about the consequences of informal business culture.

3. Reconciliation Stage: (i) develop behavioural de-biasing techniques and tools to reduce the formal-informal business culture asymmetry and (ii) institutionalise the formal-informal business culture symmetry as part of the day-to-day work.

The question of non-compliant behaviour within the financial services industry is complex and reducing the formal-informal business culture asymmetry is one factor for preventing non-compliant behaviour to arise in the future. However, it is an important factor to act upon.

An expanded version of this question will be presented by Alexandra at the 6th International Disaster and Risk Conference IDRC Davos 2016, the world's leading conference on Integrative Disaster and Risk Management, of which patronage includes international organisations, such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN), as well as private sector organisations..

Lapman Lee

THE ITERATION OF MONEY

By Lapman Lee, Financial Services Business Council (FSBC) Board Member of the European Chamber of Commerce in Hong Kong

The man on the street may not be familiar with the term "fintech", but he is already reaping the benefits of its functionality. Wherever there is an Octopus card, a smart-phone financial application or bitcoin transaction, fintech is at its core.

Financial technology, or fintech, is one of the hottest topics in financial circles these days. That is because it crosses so many levels of businesses. Most often, fintech solutions are invisible to the end consumer: they are often about transforming business models, streamlining processes and helping simplify systems. They can be technological changes to the back office that no customer will ever care about but could end up saving everyone money. Every once in a while, fintech is noticeable to the customer, like when new apps are developed.

While fintech firms have been around for the past decade - many weren't calling themselves as such. They were simply innovating. They weren't yet a part of a trend. But the more consumers and businesses started embracing digital services, the more there became a need for digital solutions. So more fintech firms were founded. Nowadays, no financial institution can afford not to be focused on fintech. Most are supporting external incubators (such as Accenture's FinTech Innovation Lab Asia-Pacific, which in 2015 had 12 supporting banks), developing their own fintech programmes internally, and looking to acquire businesses or teams of fintech startups.

The Obsession

There is good reason for the fixation on fintech. Think about it: a decade ago you probably weren't planning on using your Octopus card to pay for a beer at the 7-Eleven, or expecting to see your United Kingdom bank statement on your Hong Kong mobile phone. But now, as a customer you expect such services and more. Throw into the mix social media, vast amounts of data, ever-smarter technology and processing power not restricted by legacy systems, and you've got an environment where fintech firms are not only flourishing, they are needed to keep pace with the changes.

According to a recent report by Accenture, venture capital backed fintech investment in Asia-Pacific skyrocketed from US$800 m in 2014 to US$4.3b in 2015. According to the report, the volume of deals is set to increase slightly - at 122 as of October 1, compared with 117 for all of 2014 - but the value of deals has increased substantially due to larger investments in and from China. These include investments from Alibaba Group Holding and its Ant Financial Services Group subsidiary into Paytm, a mobile payment and commerce platform in India, as well as fundraising efforts by Ping An Insurance Group venture Lufax, which has been developing multiple alternative financing and investment platforms, including peer-to-peer and business-to-customer platforms. Indeed, payments and lending-related fintech accounted for 40% and 24% of total investment deal value.

A combination of improving but still weak investment banking return on equity (and therefore a need to innovate to grow or cut costs to stay ahead), increasing support from regulators globally for fintech, and an understanding that technological changes are occurring at unprecedented pace, has led to a greater level of acceptance of fintech. It also doesn't hurt that a number of fintech entrepreneurs were former investment bankers themselves.

Various fintech innovations will have different degrees of impact on investment banks. Blockchain's influence may be further down the pike, but innovations in behavioural analytics, social collaborate trading, and crowdfunding are all happening now. Some pose moderate levels of disintermediation.

Regulatory Help

In Britain, the FCA established the Innovation Hub, which has a stated aim of "*encouraging innovation in financial services in the interests of consumers by supporting innovator businesses with a range of services.*" The hub helps new or non-regulated firms understand more about the regulatory framework and what it means for them, as well as firms (they partner with) that are already regulated.

In Hong Kong, a government fintech steering committee is working on a policy blueprint to support Hong Kong's development into a fintech hub, where the right balance needs to be struck between facilitation (i.e. less regulatory constraints) of fintech firms introducing disruptive technologies, competition in the financial services industry, consumer protection and systematic risk, and Hong Kong's role in the regional and global economy.

Given that fintech innovation is blossoming globally and shows no signs of slowing, such regulatory assistance is welcome - it will help all parties feel confident in developing new ideas that ultimately are beneficial to the end customers.

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