DUFF & PHELPS

REGULATORY FOCUS

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

ISSUE 104

MiFID II Policy Statement (PS) Timetable

At a recent MiFID II conference the FCA confirmed its intention to issue its first MiFID II PS at the end of March 2017 and the second PS by the end of June. PS1 will address most of the issues consulted upon in Consultation Paper (CP)1 and CP2. PS2 will follow up on CP3 and CP4 and anything not covered in PS1.

The FCA also announced that it would be issuing a further MiFID II CP (probably as part of the March Quarterly CP) on some additional and consequential MiFID II matters.

MiFID II topics and challenges

As firms are preparing for MiFID II and considering the procedural and system changes that are required, we consider various topics which firms may be considering.

- **Will MiFID II's Article 17 on algorithmic trading apply to you?**
  Firms need to be aware that the definition of algorithmic trading is wider than first thought. Essentially, any firm subject to MiFID II which makes decisions to trade MiFID Instruments without human intervention, or with minimal human intervention, could be subject to the algorithmic provisions. Firms which undertake high frequency trading (HFT) are subject to Article 17, as by definition these firms demand computer driven trading systems. Firms should note however that the algorithmic trading provisions do not only apply to firms undertaking HFT.
- **MiFID II's Extra Territorial Application**
  Firms need to be careful when considering the application of MiFID II when dealing with Non-EEA firms which are not subject to MiFID II. MiFID II does not have direct extra territorial application but firms need to be aware of the indirect impact. For example, considerable care needs to be exercised in relation to the following:
  - When investment research is provided by non-EEA Brokers via 'soft commission agreements'
  - When non-EEA affiliates are undertaking transactions in which the MiFID firm has been involved, or as a consequence of the MiFID firm's delegation model, the transaction reporting requirements should be considered
  - The transparency of costs and fees generally

We remind firms that they should be reviewing the requirements of MiFID II and assessing the application of the regime to their business. If systems changes are required firms should be addressing them now as implementation is only nine months away.

We have developed a MiFID II Analyser tool which firms can purchase and use either independently or with our help to assess and track their readiness for MiFID II. For more information please, click here.

OUR RECENT AWARDS*

BEST GLOBAL REGULATORY ADVISORY FIRM
Hedgeweek Global Awards 2017

EUROPEAN SERVICES - BEST CONSULTANCY FIRM 2016
CTA Intelligence

BEST EUROPEAN OVERALL ADVISORY FIRM 2016
HFMWeek

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

BEST ASIAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014
HFMWeek

BEST EUROPEAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014
HFMWeek

BEST ADVISORY FIRM REGULATION AND COMPLIANCE 2014
HFMWeek

BEST SEC REGISTRATION TEAM - HONG KONG 2014
Acquisition International

UCITS FUND ADVISOR OF THE YEAR - IRELAND 2014
Acquisition International

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

ESMA

EMIR Margin Requirements

Under EMIR there are new variation margin requirements, which became effective from 1 March 2017.

Margin obligations apply to all OTC derivative contracts not cleared by a central counterparty (CCP). The regulation detailing the margin requirements cover two types of margin that firms are required to exchange.

Initial margin (IM) is applicable for entities with over €3 trillion of uncleared derivatives. For parties with between €3 trillion and €8 billion of uncleared derivatives the IM requirements will be phased in over the next 4 years.

The variation margin (VM) requirements applied to parties with over €3 trillion of uncleared OTC derivatives from 4 February. However, the VM obligations took effect for all other entities that are financial counterparties (FCs), or non-financial counterparties (NFCs) that have derivative transactions exceeding EMIR clearing thresholds, from 1 March 2017.

Therefore, firms subject to EMIR should have the relevant procedures in place for identifying whether the margin requirements apply, establishing detailed procedures for the exchange of margin and reviewing and updating relevant legal documentation (for example ISDA agreements).

The new rules only apply to uncleared OTC derivative transactions entered into on or after 1 March 2017. However, if an existing transaction is materially amended, counterparties should consider whether this would require variation margin to be exchanged in respect of that transaction.

The FCA has updated its EMIR webpage and produced a video that provides a more in-depth overview of the margin requirements under EMIR. This 20-minute video provides an overview of the clearing obligations and covers more detailed scenarios.

In addition, the FCA issued a statement commenting on the amount of change that the new regime will impose on some firms. The Regulator will take a risk based approach in its supervision of firms and take account of the progress made and credibility of the plans in place. Where firms cannot fully comply, the FCA expects them to have made their best efforts to achieve full compliance. Firms should be ready to explain how it will achieve full compliance as soon as possible for all in-scope trades entered into from 1 March 2017. The FCA states that it expects firms to have come into compliance within the coming few months.

If you would like to read the Delegated Regulation, please click here.

SEC update

The SEC's Office of Compliance Inspections and Examinations (OCIE) has published a Risk Alert which highlights the 'top five' deficiencies identified for Registered Investment Advisors from examinations conducted in the past two years.

Examples of deficiencies were provided under each heading:

- Failure to comply with the Compliance Rule
  - Outdated policies and procedures, which were not tailored to the business and were not followed by firms, as well as a failure to perform annual reviews
- Inaccurate and untimely regulatory filings
- Custody Rule
  - Firms did not realise that they may have custody due to the fact that they had online access to, or authority over, client accounts. In addition, some surprise examinations did not meet the requirements of the Custody Rule
- Code of Ethics Rule
  - Incomplete information in firms' Code of Ethics, access persons not identified, untimely submission of transactions and holdings and no description of code of ethics in Part 2A of Form ADVs
- Books and Records Rule
  - Incomplete, inaccurate, out of date and inconsistent records kept by some firms

The examinations within this review resulted in a variety of actions, including enhancing written procedures, changing business practises and devoting more resources or attention to the area of compliance. Some firms were referred to the Division of Enforcement for further action. In issuing the Risk Alert the OCIE encourages firms to reflect on their own operations, systems and controls and make improvements to their compliance arrangements where necessary.

We recommend that all firms that are Registered Investment Advisors with the SEC refer to this Risk Alert.

Supervision Matters

FCA and PRA publish Final Changes to Enhance Enforcement Decision Making Processes

1 February 2017

The FCA and the PRA have published PS17/1, following CP16/10, which consulted on strengthening the transparency and effectiveness of the enforcement decision-making processes.

It focuses on the following areas:

- The decision making process behind whether an issue should be referred to Enforcement and Markets Oversight or the Regulatory Action Division for investigation
- Providing more information to a person or firm about why they have been referred for investigation
- Establishing regular updates throughout an investigation and facilitating increased engagement with the subject
- Enhancing effective communication between Enforcement and Supervision during an investigation
- Improving the current guidance on the process for joint FCA/PRA investigations

The FCA also plans to introduce a process which would allow an individual under investigation to agree with certain elements of a case, for example the facts, penalties and liabilities, whilst being able to contest other elements before the Regulatory Decisions Committee. Those choosing this course of action would retain the ability to obtain a penalty discount for those areas agreed to, though the FCA is abolishing penalty discounts at Stage 2 and 3 of settlement.

In addition, the FCA will now retain the same panel that gave the warning notice to hear representations and determine if a decision notice should be issued. The FCA also intends to enhance the process of referring those under investigation to the Upper Tribunal, which provides external adjudication and is independent of the FCA.

The PRA continues to implement recommendations from previous consultations in addition to producing a guide to PRA enforcement procedures and conducting a review of the PRA's approach to settlement.

For further reading click the following links for PS17/1, CP16/10 and the FCA's press release.

FCA opens discussion on regulatory approach to open-ended funds investing in illiquid assets

8 February 2017

The FCA issued a Discussion Paper (DP) to seek stakeholders' views in relation to investment in illiquid assets, such as land and buildings, infrastructure and financial assets such as unlisted securities, through open-ended funds. The Regulator comments that investing in illiquid assets can provide investors with the opportunity to earn strong investment returns in the medium to long term. However, the Regulator recognises that there is a potential conflict between the interests of investors who want to withdraw their money and those who want to stay invested in the fund. There can be difficulties if investors expect to withdraw money at short notice and, for example, to value a fund daily that is invested in illiquid assets which are valued less frequently.

The purpose of the DP is to gather further evidence to enable the FCA to decide whether regulatory change is needed to enhance market stability and to promote competition in the sector. It discusses the processes and tools that firms use to manage liquidity risk and the benefits and risks that arise from these activities. One of the key areas of concern is the 'balance of interests' between investors who want to withdraw from the fund and those who wish to remain.

The FCA gave examples of where the market may be affected by sudden and severe changes in conditions which lead to price falls, for instance the EU referendum vote on 23 June 2016. The price fall may not be accurately reflected in the fund valuation given the difficulties in valuing illiquid assets at short notice. In this instance investors may be able to sell their holding for a higher value than it is worth, therefore, putting those investors that remain in the fund at a disadvantage. Additionally, if managers cannot accurately determine the up-to-date valuation of the fund, investors may not receive a fair price when wishing to sell.

The FCA is keen to hear from fund managers and investors to understand and hear about the issues they think exist. The deadline to provide comments to the FCA is 8t May 2017 and comments can be provided using the online response form. The FCA will review the comments, publish a response later in 2017 and will decide whether it needs to make proposals to amend the existing rules.

If you would like to read the full Article or the Discussion Paper, please click here.

What makes good conduct regulation

14 February 2016

The Chairman of the FCA, John Griffith Jones has delivered a speech in which he highlights the Regulator's expectations as to what constitutes good conduct regulation and linked this to the FCA consultation on its own Mission Statement. As conduct risk and culture are not defined in the FCA Handbook, such speeches provide insight into FCA priorities and areas of focus in the years ahead.

Mr Griffith Jones identified five building blocks that help create an optimal outcome for conduct regulation and his thoughts are summarised below.

Government policy

Regulation is needed in instances where the free market produces results that are contrary to government's policy. Such measures are usually taken in respect of social and economic policy. It is up to the Government to establish clear policy on relevant regulatory issues. Experience indicates that regulation acts most effectively as a support for government policy, rather than as a replacement. While regulation cannot be totally independent of government, regulators should be independent when discharging their duties.

Clear objectives and perimeters

While the FCA's operational and strategic objectives are clear, they are high level and as such it can be difficult for firms to understand the regulator's attitude to individual issues. The FCA's work on its Mission will look to add further detail in this area. Defining perimeters, such as which transactions, products or services are covered by regulation, can also be problematic and the Regulator is constantly looking to meet this challenge.

Risk tolerance

Quantifying 'acceptable detriment' is difficult to do when considering the issues involved in financial regulation. When the Regulator assesses potential detriment, distinction is made between ex ante and ex post approaches. With regards to the latter, often the speed of response to early signs of trouble is key to containing the scale of damage that may occur.

Operational excellence

At a macro level, effective deterrence is integral to operational excellence, with the goal being for firms to effectively self-regulate. The FCA plans its actions so that the proportionality of its rules, and the chances and consequences of being caught for committing rule breaches, will ultimately align firms' self-interest with the desired regulatory outcome. The Chairman pointed to the 'powerful example of this in practice' when mentioning the Senior Managers' Regime and the importance of individual accountability. At a micro level, the key component to effective regulation is the exercise of good judgement from the conduct regulator.

Measurement and transparency

The National Audit Office's recent paper, 'Performance measurement by regulators', establishes some key concepts for measuring success and failure with regards to regulation. Measurement of good conduct, and the availability of this information to the public, is valuable as it can show that progress is being made. Key indicators, such as surveys, reported complaints and suspicious activity levels, are useful for painting a picture of the conduct environment. While these soft measures cannot at this early stage be said to indicate success in the FCA's case, they do suggest that the industry is headed in the right direction. It also points to the signs and indicators the FCA will use in determining whether firms are managing conduct risk appropriately.

In conclusion the Chairman commented that the split of the old FSA had resulted in increased clarity and focus on the concept of conduct regulation. Mr Griffith Jones said that there is little academic research into 'what works best' for conduct regulation. The building blocks described above are current thoughts and remain a work in progress but there is some way to go.

To read the full speech, please click here.

FCA reviews effectiveness of UK primary capital markets

14 February 2017

The FCA, in Discussion Paper DP17/2, seeks feedback on the effectiveness of the UK primary capital markets. It was published in tandem with Consultation Paper CP17/4, which proposes technical enhancements to the UK Listing Rules.

In DP17/2 the FCA sets out its views on the following:

- The appropriateness of the boundary between standard and premium listing categories, especially in relation to overseas issuers and exchange traded funds
- The practical role of standard listing
- The UK primary markets' effectiveness in providing capital for growth with a focus on early stage science and technology companies
- The potential utility of a UK primary debt multilateral trading facility and the structure it would take
- Measures to assist an increase in retail participation in the UK debt markets

Furthermore, taking into account stakeholder feedback, the FCA proposes the following changes to the Listing Rules in CP17/4:

- Clarifying the premium listing eligibility requirements
- Establishing a concessionary route for property companies to become premium listed
- Updates to the manner in which listed issuers may classify transactions and changing requirements on when they should contact the FCA
- Altering the FCA's approach to the suspension of listing for reverse takeovers

Both publications are part of the FCA's wider review of the efficiency and effectiveness of UK primary markets as set out in the 2016/17 Business Plan. The consultations in DP17/2 and CP17/4 will close on 14 May 2017 with a Policy Statement expected in Q3 2017.

DP17/2 can be found here and CP17/4 can be found here.

Regulation round up - February 2017

16 February 2017

This month the Director of Supervision, Megan Butler, provided feedback on the FCA's recent supervisory work which focused on the practices of firms when acquiring clients from another entity.

Whilst some positive practices where observed, Ms Butler highlights that the interests of clients were not always paramount. Firms concentrated on the commercial benefits but did not give appropriate consideration to how clients would be impacted by an acquisition. Particular examples were provided where clients were not given enough detail regarding fees, charges or who to contact if they had a complaint with the new firm. In addition, where new client agreements were required, firms did not always wait until they had the client's consent before facilitating advisor charges to be redirected to their own client accounts.

Reasons often cited by firms for falling short of the Regulator's expectations were inadequate planning or resources.

The FCA states that it expects all firms to now consider the content of the report and assess whether they need to improves their own practices and procedures.

Insight article

15 February 2017

New data available to the Regulator suggests there has been a decline in liquidity in the UK's corporate bond market since 2014/5 which is potentially due to trading conditions becoming more difficult. The UK's secondary market for corporate bonds is the largest market in Europe.

The full analysis and link to the FCA article can be found here.

Cancelling FCA permissions

Firms have been reminded by the FCA that any applications to cancel FCA permissions submitted after 31 March 2017, or 28 February 2017 for dual regulated firms, will mean that firms will be liable for periodic fees for the following year.

Regulation round-up special edition

23 February 2017

The FCA has issued a special edition of its 'regulation round-up' which focuses on its recent consultation on the future financing of the Financial Services Compensation Scheme (FSCS) and how the system could be improved. The Regulator highlights the sections of the consultation which it believes are most relevant to individual sectors and encourages stakeholders to provide feedback.

Please click here to read the article.

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