DUFF & PHELPS

REGULATORY **FOCUS**

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

ISSUE 105

MiFID II Key Topics and Challenges

Will the new transaction reporting requirements apply to you?

As most firms will now be aware, the obligation to make transaction reports will widen under MiFID II. These are contained in MiFIR Article 26 and in RTS 22. It applies to MiFID investment firms undertaking relevant transactions, including those which undertake discretionary investment management and currently rely on the Portfolio Manager Exemption in SUP 17. The FCA confirmed in Policy Statement 17/5, issued on 31 March 2017, that it will not apply to AIFMs when undertaking either collective portfolio management for AIFs or individual portfolio management. However, the transaction reporting requirements will now also apply to Exempt CAD Firms if they are undertaking reception and transmission of orders.

For those firms affected, transaction reporting is one of the biggest changes under MiFID II.

The number of data fields to be completed for transaction reporting purposes will increase from 23 to 65, so there is a large impact, even for firms who are already subject to the transaction reporting requirements.

If a MiFID investment manager transmits an order to another firm for execution, it can rely on the other firm to report the transaction if certain conditions are met. However, the conditions are onerous for the transmitting firm and so far, we are seeing little appetite for managers to take this route.

The new requirements will come into force on 3 January 2018. We recommend that, if you have not already done so, you should review how the rules will affect your business, the changes required, and resources and systems needed. Then work out a timetable to take account of testing and finally, speak to vendors to prepare for MiFID II transaction reporting as soon as possible.

Our MAST: MiFID II Analyser Solution and Tracker can help your business navigate the imminent change in EU legislation. Read more about how Duff & Phelps can help, here.

OUR RECENT AWARDS

BEST COMPLIANCE CONSULTING TEAM
Women in Compliance Awards 2017

BEST GLOBAL REGULATORY ADVISORY FIRM
Hedgeweek Global Awards 2017

EUROPEAN SERVICES - BEST CONSULTANCY FIRM 2016
CTA Intelligence

BEST EUROPEAN OVERALL ADVISORY FIRM 2016
HFMWeek

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

BEST ASIAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014*
HFMWeek

BEST EUROPEAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014*
HFMWeek

BEST ADVISORY FIRM REGULATION AND COMPLIANCE 2014
*HFMWeek**

BEST SEC REGISTRATION TEAM - HONG KONG 2014*
Acquisition International

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

Supervision Matters

Firms continue to fail to meet FCA expectations on the use of dealing commission

3 March 2017

Between 2012 and 2015, the FCA conducted a review that analysed the use of dealing commission across 31 investment managers, 17 of which were visited by the FCA. The review follows the thematic review of 'conflicts of interest in asset management firms' conducted by the FSA in November 2012, together with a policy statement on the use of dealing commission rules published in May 2014.

The FCA sought to understand how firms had responded to the examples of good and poor practice detailed in its discussion paper on the use of the dealing commission regime published in July 2014.

Of the 17 firms the FCA visited, it was considered that the majority were not meeting the Regulator's expectations and poor practices were identified, with some firms continuing to use dealing commission to purchase non-permissible items. The FCA also found that many firms were unable to demonstrate any improvements with regards to how their customers' money was spent when using dealing commission.

The FCA found failings with regards to the systems and controls in place together with record keeping requirements. COBS 11.6.5E notes that firms should have arrangements in place which demonstrate that only 'substantive' research is paid for using dealing commission. The FCA found that the records in place were insufficient, and it expects to see 'clearly documented evidence to support the acquisition of permitted goods and services'.

Only a few firms visited were found to have systems and processes in place which ensured that detailed information was recorded for all substantive broker interactions, enabling the firms to explain the rationale behind research commission expenditure. The FCA confirmed that during future reviews it will seek confirmation that Boards are requesting satisfactory management information on the subject.

Conflicts of Interest

It was noted that Firms which have poor systems and controls and poor record keeping requirements could be susceptible for failing to identify a conflict of interest or an inducement risk which consequently may not be managed or monitored effectively. It found that many firms continued to treat the receipt of corporate access from brokers as a free provision, leaving the firm open to the risk that corporate access or other non-permissible services might influence the allocation of dealing commissions. The FCA did, however, find that a limited number of firms attempted to mitigate this risk by paying for the service out of their own resources.

Research Payments

The FCA found that a few firms were covering the cost of external research through their own resources. This approach helps to ensure that firms are encouraged to only purchase research that represents value for money, promotes greater transparency and mitigates the conflicts of interest with regards to using dealing commission to pay for research. Firms that adopted this approach were also found to only use dealing commission for execution-only services and the service was paid at execution-only rates. Other firms have adopted practices that demonstrates good controls over how they spend dealing commission. Either approach should drive better quality research across the market.

Research Budgets

The FCA also sought to understand how firms' research budgets are set and managed. It found that many firms use historical research spending levels to set budgets rather than assessing the amount of research necessary. There were also firms that did not perform any budgeting, and the spending levels were closely correlated to trading volumes. Having procedures in place to budget for research should increase discipline around how much client money is spent on it. Where budgets are set but the expenditure for research is not limited, the FCA expects to see a satisfactory explanation as to why this is the case as this could result in a breach of the requirement to act in the client's best interests. In circumstances where expenditure is less than the budget, this should also prompt a review to question whether the budget was set unnecessarily high.

Research polls and voting

Several firms adopted a research poll approach, which required analysts and portfolio managers to allocate votes generating research payments based on percentages of the total research, rather than specified monetary amounts. The FCA found that these firms were typically unable to assess value for money and demonstrate that they were paying for research appropriately using client's money.

In conclusion, the FCA highlighted more that needs to be done to ensure that investment management firms spend their customers' money with as much care and attention as if it were their own.

The FCA also made it clear that when a firm outsources its activities and delegates investment management services overseas, it must ensure that controls are in place to assure that the FCA's rules are complied with.

Additionally, MiFID II, which will come into force in January 2018 brings changes to this area and it is likely that the use of dealing commission will continue to be an area of focus for the FCA.

If you would like to read the full article, please click here.

Investment managers failing to ensure effective oversight of best execution

3 March 2017

The FCA has outlined its findings from supervisory work that was conducted to determine how investment managers deliver best execution to their clients.

It highlights that several pieces of work have been completed on the topic and a thematic review published, all of which ought to have been considered by regulated firms and acted upon, where appropriate.

Many firms had not performed a robust gap analysis since 2014 and as a result several of the poor practices outlined in the previous thematic review had not been considered or addressed.

The FCA did note that some firms had good practices in place, namely considering best execution throughout the investment decision making process, and encouraging deal teams to provide portfolio managers with feedback on their preferred trading strategies. Additionally, it was noted that there had been improvements in the provision of best execution with regards to equity investments, with firms using low cost trading venues, direct market access and broker supplied algorithms to reduce cost.

Also, whilst many firms had management information in place to monitor best execution, the Regulator noted this was often used to 'tick boxes' as opposed to being used to improve best execution for clients. Whilst it was observed in some firms, effective challenge provided through the monitoring process was not possible as monitoring teams were denied access to information required to conduct their review.

The FCA highlighted what firms should consider as part of their review:

- Which individual is ultimately responsible for ensuring the firm continues to meet the best execution expectation?
- What is the firms oversight strategy of best execution?
- Is there a test to ensure that funds and client portfolios do not pay too much for execution? And, where this is identified, are they compensated?
- Is it a tailored execution policy which reflected the firm's business model?
- What trends have been identified through monitoring?
- Is the gifts and entertainments policy in line with guidance set out in Finalised guidance 14/1 and the FSA's 2012 Dear CEO letter?
- Have staff received regular training to ensure they understand what best execution means and how can this be evidenced, if asked?

The FCA will revisit the topic of delivering consistent best execution for clients in 2017 and will assess what steps firms have taken to address the Regulators concerns. The FCA's full press release can be found here.

FCA publishes Quarterly Consultation Paper No. 16

3 March 2017

The FCA has published its most recent quarterly consultation paper, CP17/6, addressing miscellaneous amendments to the FCA Handbook. This Consultation Paper proposes the following changes:

1. Changes to DEPP and EG which reflect the FCA's powers in light of the Bank Recovery and Resolution Order 2016
2. Changes to MAR relating to ESMA's guidelines on commodity derivatives
3. Changes to SUP and EG arising from the extended Immigration Act 2014 (as amended by the Immigration act 2016)
4. Changes to PR1.2.3R that anticipate new Prospectus Regulation and an update to ESMA publication in conjunction with amendments to the Listing Rules Sourcebook
5. Changes to MAR 5.6 and REC 3.9 which would introduce a standard template for the notification of liquidity incentive schemes in relation to Recognized Investment Exchanges ("RIE"), and Multilateral Trading Facilities in addition minor amendments in REC 2.3 regarding the provision of guidance to RIEs
6. Changes to COBS and MCOB to improve firms' communication with consumers.
7. Changes to reporting requirements in the supervision manual

Consultation for all proposed changes, except those relating to PR1.2.3R, will remain open until 3 May 2017.

The full text of CP17/6 can be found here.

FCA regulatory reference rules come into force

7 March 2017

The new regulatory reference rules, which were published in September 2016 at part of Policy statement PS16/22, have now come into force. These rules, which were drafted in anticipation of the Senior Managers Certification Regime (SMCR), have been added to the FCA handbook in SYSC 22.5 and make the following stipulations:

- Regulated firms still operating under the Approved Person Regime must disclose upon request all relevant information relating to a current or former employee's fitness and propriety over the past six years within six weeks of receiving a request from a SMCR firm
- SMCR firms will be obligated to update references where information comes to light, within six years of termination, that would change the reference given and would be of significance to the current employer's assessment of the fitness and propriety of the individual in question
- Hence, asset managers may now receive updated references regarding the fitness and proprietary of existing staff who were previously managers or certified persons in a SMCR firm

While currently only applicable to SMCR firms, these rules will likely be extended to all firms as part of the wider application of SMCR to all regulated firms. The FCA has confirmed it will consult on this topic in Q2 2017.

The full text of PS16/22 can be found here.

Senior Managers and Certification Regime: One Year On

7 March 2017

7 March 2017 marked one year since the Senior Managers and Certification Regime ("SMCR") was introduced by the FCA and PRA with the objective of increasing individual accountability and responsibility. The regime currently impacts banks, large investment firms and insurers.

One year on, the FCA's rules on regulatory references for Senior Managers and staff in the Certification Regime have now come into effect. These new measures apply to individuals in roles that can cause 'significant harm' to either the firm itself or its customers e.g. investment and mortgage advisers. In addition, the Conduct Rules, applicable to Senior Managers and staff in the Certification Regime for the last year, have now been extended to all staff other than those conducting purely ancillary functions. The deadline for firms to issue certificates for staff in the Certification Regime was also 7 March 2017.

In terms of assessing how effective implementation has been to date, the Regulator has noted evidence of overlapping responsibilities among individuals within firms. In some cases, specific responsibility appeared to be shared among employees at different levels of management, resulting in a lack of clarity over who was ultimately accountable. However, the FCA has also recognised progress within the industry, noting a general trend of firms adapting to a culture of individual accountability.

The Bank of England and Financial Services Act 2016 will extend the SMCR to all sectors of the financial services industry from 2018. The FCA has stated that it intends for the extended regime to be "clear, simple and proportionate" and will be consulting on the proposals during Q2 2017.

For further information, please click here.

Guidance on the treatment of Politically Exposed Persons (PEPs) under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017

16 March 2017

The UK is required to update its anti-money laundering regime by 26 June 2017 by transposing the 4th Money Laundering Directive ("4MLD"). The Money Laundering and Transfer of Funds (Information on the Payer) Regulations 2017 ("Regulations") contains guidance on the interpretation of the term 'politically exposed persons' ("PEPs") and appropriate due diligence measures that should be undertaken.

The current Money Laundering Regulations 2007 requires enhanced due diligence to be undertaken on PEPs (people who hold high public office), and their immediate family members or close associates, in states other than the UK. The 4MLD has expanded this definition to include individuals holding prominent positions in the UK, as well as their family members or close associates. Therefore, the Regulations provide guidance on how firms should treat customers who are PEPs when meeting their anti-money laundering obligations.

The Regulations clarify who should be considered a PEP, a family member of a PEP, or a known close associate. For example, a PEP will include an individual who is entrusted with a prominent position either in the UK or abroad, and this can include heads of state or government, including ministers and deputy ministers as well as members of parliament. Members of governing bodies of political parties, members of supreme courts or constitutional courts as well as high-level judicial bodies will also be included within the definition of PEP.

However, whilst the definition of PEPs has expanded, it is expected that firms should take a proportionate and risk-based approach with undertaking due diligence on PEPs. It is not anticipated that firms should refuse business with PEPs unless it is found that they pose a high money laundering risk.

Within the Guidance Consultation, the FCA has also provided information on risk indicators for PEPs, their family members and close associates. For example, PEPs operating in countries which have low levels of corruption, or are subject to rigorous disclosure requirements can be viewed as lower risk. As opposed to PEPs based in countries which experience political instability, armed conflict or are governed by non-democratic governments. The Guidance Consultation paper provides detail on due diligence processes and measures that should be undertaken in higher or lower risk situations and confirms the level of involvement from senior management in regards to the approval of these relationships.

As the law requires guidance to be in place by 26 June 2017, comments in the contents of this paper should be returned to the FCA by 18 April 2017.

Mark Carney's speech: "Worthy of trust? Law, Ethics and Culture in Banking"

21 March 2017

The Governor of the Bank of England (BoE) has given a speech highlighting the cause, impact and plans to address the current laws and ethics in the banking industry.

Mr Carney highlighted the twin crises in banking: solvency and legitimacy, which had a detrimental effect on public trust in the financial system. Whilst solvency is being addressed by progress in comprehensive reforms, this was overshadowed by a crisis of legitimacy through recent scandals involving miss-selling and manipulation.

The term *"ethical drift"* was used to describe bad behaviour which eventually becomes the norm with the monetary effect of such misconduct amounting to over $ 320 billion.

It was the BoE's intention to convert this *"ethical drift into ethical lift"*.

As part of a 'UK Action Plan', Mr Carney explained this will begin with stronger deterrents and a goal of strengthening of laws and regulations, though fines and sanctions alone will not bring about the cultural change required.

However, for codes to be of use, they must be read, followed and enforced. This is where the UK's Senior Manager's Regime comes in.

Senior Manager's Regime (SMCR)

The SMCR re-establishes the link between seniority and accountability.

It prescribes responsibility for developing and embedding a firm's culture, typically with the Chair and the CEO respectively.

The related Certification Regime (CR) also requires firms to annually assess and certify the fitness and propriety of risk-taking employees.

It was noted the SMCR is having the effect of putting firm culture to the top of senior managers' agendas, helping to clarify and improve governance, accountability and decision-making for firms and helping supervisors identify weaknesses. He also pointed out that its adoption is spreading, with firms voluntarily taking on elements of the SMCR to strengthen their global operations.

The SMCR has been adopted by the BoE, as part of their commitment to high standards of governance and accountability. Recently, it emerged that Charlotte Hogg (newly appointed Deputy Governor for Markets and Banking) had not previously disclosed a family connection, as required under the Code of Conduct. The BoE's response and the consequences were consistent with the high standards set by the SMCR and the BoE, including a strong and formal public warning, the forfeiture of a salary increase and reassigning her COO responsibilities. Ultimately however, the Treasury Select Committee reached its own decision which led to Ms Hogg's resignation.

Carney used this incident as an example the industry might draw lessons from, however he was keen to dispel the urban myth that has developed around it. He stated that while the PRA may issue financial penalties and suspensions under the SMCR, it's not a "one strike and you're out" system. Rather, the SMCR is about clear responsibilities and proportional consequences, as well as openness and accountability.

Carney concluded his speech by stating that financiers must challenge themselves and the standards they uphold: integrity can neither be bought nor regulated. He outlined that cultural change takes time and the BoE's own efforts over several years to overhaul governance, openness and transparency. However, he recognised that there is more to be done.

The Bank's next strategic plan is to embrace fully collaborative working in diverse teams that value robust debate, improving internal and external communication. This will aid the BoE to build the trust that is crucial to deliver its mission.

The full speech can be found here.

Joint Money Laundering Steering Group (JMLSG) publishes proposed revisions to Part I of its Guidance

21 March 2017

The JMLSG has commenced its consultation on proposed updates to its Part I Guidance. The changes reflect rule changes being brought in by the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the new regulations).

Chapters one to eight of Part I of the Guidance have been updated in line with the new regulations. The risk-based approach section in chapter four has been reordered so that its presentation of the risk assessment and approach is laid out more clearly. Significant changes have been made to the section in Chapter five on material on electronic verification to ensure that it is in line with digital advances in technology.

The deadline for feedback on the consultation is 28 April 2017.

FCA publishes MiFID II Implementation Policy Statement and Consultation Paper

31 March 2017

The FCA has published PS17/5, Its First policy statement on MiFID II implementation. PS17/5 addresses most of the aspects consulted on in the first two MiFID II consultation papers (CP15/43 and CP16/19), including the following:

- Trading venues
- Transparency waivers and deferrals
- Algorithmic and High Frequency Trading
- Position limits and reporting for commodity derivatives
- Systems and controls requirements and
- Remuneration

These rules should be considered "near final" and a second policy statement will be released in June 2017. The FCA is encouraging firms impacted by the changes under MiFID II that require authorisation or variation of permission to apply for these as soon as possible or risk being unable to operate in the UK market after 3 January 2018.

The Policy Statement also covers some smaller issuers from the latter two consultation papers (CP16/29 and CP16/43) along with an update on FCA's thinking regarding its proposals for recording telephone conversations (CP16/29).

The FCA has also published its fifth consultation paper (CP17/8) which sets out the proposed approach to non-discretionary changes linked to MiFID II, notably the following:

- Parts of the Handbook dealing with penalties and enforcement
- Guidance on the use of third parties Consequential and miscellaneous changes to the FCA Handbook
- To send the FCA financial instrument reference data or commodity derivative position reports and
- Revisions to the conduct rules for non-MiFID Occupational Pension Scheme (OPS) Firms

The consultation will be open until 12 May 2017 for all aspects of the consultation paper save Chapter 2, relating to OPS firms, where consultation will remain open until 23 June 2017.

Click the links for the full text of PS17/5 and CP17/8.

Enforcement Matters

Retail Giant to pay Redress for Market Abuse

28 March 2017

A British multinational grocery and general merchandise retailer ("the Firm") has agreed that it committed market abuse and will pay compensation to investors that were adversely affected. The abuse relates to an announcement made in August 2014. This is the first time that the FCA has exercised its powers under Section 384 of the Financial Services Markets Act ("FSMA") to require a listed company to pay restitution for market abuse.

On 29 August 2014, the Firm released a trading update stating its expected trading profit for the half year ending 23 August 2014 to be near £1.1 billion. This was followed by a trading update on 22 September 2014 which announced the Firm had "identified an overstatement of its expected profit for the half year." Accelerated recognition of "commercial income," promotional discounts and rebates received from suppliers, and delayed accrual of costs were cited as reasons for the estimated £250 million overstatement. The Firm's Board could have known or been reasonably expected to know that the information published on 29 August was false or misleading although the FCA is not suggesting that this is the case.

In the period between the misleading statement and the corrective statement approximately 10,000 institutional and retail investors purchased 320 million shares at a higher price than they would have if the misleading information had not been released. A compensation scheme will be launching on 31 August 2017 for investors who acquired shares after the misleading announcement and continued to hold some or all those shares on the last trading day before the corrective statement. Those eligible to claim under the scheme will receive compensation equal to the amount that their relevant shares were inflated. The FCA estimates the total amount of compensation paid out under the scheme will be in the region of £85 million plus interest.

This announcement was published on the same day that the Serious Fraud Office ("SFO") announced it had entered a deferred prosecution agreement with the Firm relating to false accounting practices. Because of the SFO's findings the Firm will be fined £128,992,500. Considering the SFO's enforcement action and since the Firm has accepted responsibility for market abuse and agreed to the compensation order under FSMA, the FCA will not impose any further financial penalties.

The FCA's press release can be found here.

FCA fines former investment banker for sharing confidential information over WhatsApp

30 March 2017

The FCA has fined an individual, who was a managing director in the Investment Banking Division of an American global Investment Bank, ("the Bank"), £37,198 for sharing client information over the encrypted mobile app WhatsApp.

The Individual received confidential client information during his employment and on several occasions between 24 January and 16 May 2016 he chose to divulge this information to both a personal acquaintance and a friend. The information shared included the identity of clients, details relating to the client mandate, and the fee that the Bank would charge for its involvement in specific transactions. The friend in question was also a client of the Bank and in one instance the confidential information disclosed related to a competitor.

None of the people involved dealt in any securities relating to these disclosures and there is no evidence to suggest market abuse was attempted. The Individual's rationale for disclosing this information was not to make a financial gain but rather to impress his acquaintances. This is evidenced by the boastful language of the messages and in one the Individual claims that if the deal he is describing is successful he would 'be able to pay off the mortgage on his house.'

The Individual provided full admissions to the FCA and agreed to settle during stage 1 of the settlement period. Had this not been the case the financial penalty imposed would have amounted to £53,140. He was suspended by the Bank and resigned before its internal disciplinary process was completed.

The FCA's full press release can be found here.

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