REGULATORY FOCUS

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

ISSUE 106

MiFID II topics and challenges

Organised trading facilities (OTFs)

MiFID II introduces a new category of trading venue, the organised trading facility (OTF). This will be a multilateral system in which multiple buying and selling orders can be matched. OTFs will only relate to trades in bonds, structured products, emission allowances or derivatives, so not equities. In addition, OTFs will only be used for discretionary trades. An OTF must be at least a €730k Limited Licence Firm.

MiFID II is technology neutral and permits any trading protocol to be operated by an OTF, provided it is consistent with fair and orderly trading.

MiFID II and MiFIR aims to implement a level playing field across trading venues, so the requirements for multilateral trading facilities (MTFs), regulated markets (RMs) and OTFs are similar, covering areas such as organisational requirements, transparency, procedures for fair and orderly trading and fee structures. There are also requirements around having resilient systems and sufficient capacity to ensure orderly trading under stress.

There has been some confusion about whether a firm which has permission to deal as principal with a matched principal limitation in relation to the relevant instruments, should now seek authorisation as an OTF, to be effective from 3 January 2018.

For a firm to establish whether it is an OTF, it needs to review its operations and assess whether:

- the way in which it trades for clients constitutes "operating systematically"
- its operating model would permit matching orders with multiple counterparties
- the Firm's system would be deemed 'multilateral'

We are aware that many firms holding a matched principal limitation match one buyer with one seller, so operate on what's known as a 'bilateral' basis.

We recommend that firms that have permission to deal as principal on a matched principal basis obtain a legal opinion on whether the way they operate means that they must apply for authorisation as an OTF. If firms do need to be authorised as an OTF they must have submitted a "complete" Variation of Permission application to the FCA by 3 July 2017.

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

ESMA Q&As

ESMA issued two updated Q&As on MiFID II during April. These covered investor protection, which included the following topics:

- Best execution
- Suitability
- Post-sale reporting
- Inducements (Research)
- Information on charges and costs
- Underwriting and placement of a financial instrument

and Market Infrastructure, clarifying issues such as that mentioned above on OTFs.

Please find the ESMA Q&A on investor protection topics here and the ESMA Q&A on market structure topics here.

Application of Algorithmic Trading Provisions to Alternative Investment Fund Managers (AIFMs)

The algorithmic trading provisions (MiFID II Article 17) do not apply to Collective Portfolio Management (CPM) firms or Collective Portfolio Management Investment (CPMI) firms unless they are members of a trading venue.

Please note that this does not mean that firms directly subject to MiFID which are not members of a Trading Venue are also out of scope of these rules. This is because CPMs and CPMIs are only indirectly subject to MiFID.

Supervision Matters

The case for innovation in financial services

10 April 2017

Christopher Woolard, Executive Director of Strategy and Competition at the FCA, has delivered a speech in which he discussed the Regulator's approach to innovation within financial services.

The speech focused on the FCA's aims, future plans and what it has accomplished so far.

The FCA sees innovation within financial services as a means to achieving better outcomes for consumers, in terms of products and services. It looks to encourage innovation as shown through the introduction of the Regulatory Sandbox and this year it organised a working group to explore options for an industry-led virtual sandbox.

By supporting innovation within the industry, the Regulator is looking to satisfy three measures of success:

- Are more innovative firms entering the market?
- Is there greater innovation and competition by and between larger firms?
- Are consumers benefiting from that?

Mr. Woolard mentioned that whilst there has been a noticeable dip in innovative firms wanting to operate in the UK in the immediate aftermath of the EU referendum, activity in the sector indicates that the UK remains attractive to such firms. In addition, the Regulator is now working more closely with innovators, as demonstrated by the increased use of the Regulatory Sandbox and the Regulator's Advice Unit.

The FCA has also recently signed co-operation agreements with colleagues in China, Japan, Canada and Hong Kong. The aim here is to achieve "responsible innovation" which should enhance outcomes for consumers. Long term, the FCA aims to build a common understanding of the underlying principles of good innovation, to benefit international cooperation and secure the industry's long-term future. The regulator will be looking to work with the G20 and IOSCO to further develop these goals.

Closer to home, the FCA has noted the emergence of FinTech hubs outside the London area, specifically the Edinburgh-Glasgow corridor and the Leeds-Manchester area, where the FCA believes it can add value. The Regulator aims to work with the local authorities, development partners and firms in these areas, and will be offering a regular presence from the Innovation Hub which will provide informal guidance to firms seeking to innovate.

To read the full speech, please click here.

FCA Business Plan 2017/18

18 April 2017

The FCA has issued its Annual Business Plan which aims to highlight the most important issues in each of the sectors it regulates and sets out its priority work for the year ahead

Cross-sector priorities

In particular, the Regulator highlights its cross-sector priorities as follows:

- Culture and governance
- Financial crime and anti-money laundering
- Promoting culture and innovation
- Technological change and resilience
- Consumer vulnerability
- Treating customers fairly

Brexit is also highlighted as a key event which may impact developments in the year ahead and creates a risk of disruption to the FCA's Business Plan priorities. The Regulator is working alongside the Government to share technical resource, to ensure it continues to fulfil its statutory duties and to ensure that the financial sector remains resilient.

The topic of cyber resilience is highlighted as one of the key risk areas to emerge, due to the increasing sophistication, scale and frequency of cyber-attacks. A firm's resilience against such attacks is key to any potential impact on consumers, clients and the market.

Sectors

Seven sectors are defined by the Regulator:

- Pensions and retirement income
- Retail banking
- Retail lending
- General insurance and protection
- Retail investments
- Investment management
- Wholesale financial markets

The FCA asks that firms read and become familiar with the sector views and those which are most relevant to its business activities to gain an understanding of what the FCA expects, the current issues and its planned work in each sector.

Investment Management

The Regulator seeks the following outcomes in the Investment Management Sector:

- Firms act in the best interests of its investors
- Investors reward firms that act in their best interests
- Investment management products deliver value for money
- Investors understand the value of the funds they invest in
- Appropriate fund benchmarks are utilised
- Fund managers implement available liquidity tools when facing client redemptions and manage conduct risks effectively. Fund managers remain responsible participants in the wholesale markets

The Regulator has identified the following risks and potential issues:

- Weak price competition
- Weak governance
- Poorly managed Conflicts of Interest
- Poor advice from investment consultants
- Poor liquidity management
- Disorderly failure of investment portfolios
- Providers of critical services not being able to meet service standards

The FCA also mentions that its final report on Asset Management and Market Study will be published in Q2 2017.

Wholesale financial markets

Similarly, the FCA seeks the following outcomes for wholesale financial markets:

- Clean, effective and competitive wholesale markets
- Key market infrastructure remains resilient
- Growing cross industry collaboration on cyber risk
- Strengthening monitoring and surveillance capability of the FCA, market participants and market infrastructures to detect, disrupt and deter market misconduct
- Increased efficiency and effectiveness of primary markets
- Corporate and individual market participants take responsibility for maintaining clean, fair, effective and competitive markets. Firms and individuals understand the standards and rules that apply to them and are held accountable for their conduct

It has identified the potential issues:

- Firms fail to manage their conflicts of interest
- Firms fail to identify and manage market abuse risks
- Firms fail to manage financial crime risk
- Effective competition is undermined
- Increased electronic and digital services and systems
- Markets fail to provide a good environment for issuers to raise finance

If you would like to read any of the reports in further detail, please click here.

FCA Mission Statement

18 April 2017

The Regulator has also published its 2017 Mission Statement (MS), which follows the mission consultation it published in October 2016. Over 150 individuals and organisations responded to the 2016 consultation providing varied feedback.

The document sets out the framework for the strategic decisions that the FCA will make in the year ahead, the reasoning behind its work and the way it chooses the relevant tools to conduct such work. It describes both current practices within the FCA and other aspects that will be given greater emphasis in the future.

The Annual Report due to be published later in 2017 will show how the Regulator has performed against set goals. The FCA also intends to publish further information on how the detail published in the MS is reflected in the key FCA areas:

- Authorisation
- Supervision
- Enforcement
- Encouraging competition
- Influencing market design

If you would like to read the press release in full, please click here.

CP17/12: FCA Regulated fees and levies: rates proposals 2017/18

18 April 2017

The FCA state in CP17/12 that the annual funding requirement for 2017/18 will increase by 1.5% to £526.9m, equating to an increase of £7.6m. The FCA is consulting on its proposed fee rates and has requested comments be sent via the response form by 9 June 2017. The full document can be accessed here.

Nausicaa Delfas, Executive Director, FCA, delivers speech on cyber security

24 April 2017

Nausicaa Delfas, Executive Director at FCA, delivered a speech at the Financial Information Security Network on Cyber Security. This speech is relevant for all firms and covers the following:

- The threat landscape and the fact that it is ever evolving
- All firms need to be able to prevent, detect, recover and respond
- They need to get the basics right and move to a secure culture.

Ms. Delfas refers to the 2016 Verizon Data Breach Investigations Report which highlights that 10 vulnerabilities accounted for 85% of successful breaches.

There are also the 10 steps to cyber security which is considered by UK Government, and the UK Financial Authorities, as the basics of what is deemed 'good cyber hygiene' highlighting that it's a common statistic that the 10 steps to cyber security, properly implemented, would eliminate around 80% of the cyber threat firms are struggling to manage.

The FCA urges financial institutions to carry out robust and comprehensive risk assessments focused on the impact of a DDoS (Distributed Denial of Service) attack on their systems.

It asks that Firms consider concentration risk when subscribing to a given service, to avoid contamination in the event of widespread sector attacks.

In addition, the Regulator comments that due diligence of third party suppliers should include a review of their cyber resilience. They should also ensure that they have controls in place to swiftly recognise when an attack has happened in a third-party supplier and have plans in place to correct or reduce undesirable outcomes.

Examples of this include: introducing fake phishing scams, educating staff who click on them, rewarding those who avoid/spot attacks and taking further action on those who persistently do not.

The FCA has been impressed with the number of firms who have started to adopt such approaches.

Ms. Delfas also noted that an interesting area of study within the FCA is the potential measurement of security culture. Whilst it is too early to say if it will reach meaningful conclusions about how such a qualitative and intangible concept is measured, perhaps by setting key performance indicators and success criteria, it can begin to start looking at measuring security culture and setting the baseline for improvement in a more quantitative way. For example, by aggregating the outcomes of ethical phishing exercises, red team tests, senior leadership exercises, staff awareness events and information security training, the FCA can begin to gather baseline metrics against which to track improvement. By tracking improvement, it can begin to take tangible steps to improve our cultural attitude towards security and start to tackle the more difficult challenges emanating from within our organisations.

Ms. Delfas highlighted the role of the Non-Executive Directors (NEDs), the benefit of them being able to share experiences from other businesses, and to ask challenging questions of their board colleagues, and senior leaders within an organisation. In 2014 the UK Government released guidance for NEDs on the types of questions that should be asked and the Regulator very much supports this advice. NEDs should be able to satisfy themselves that an organisation is managing cyber risk effectively. The Institute of Directors specifically calls for NEDs to satisfy themselves "that systems of risk management are robust and defensible".

The FCA has established several Cyber Coordination Groups, or CCG's, to achieve a better collective cyber capability. It is also collecting, anonymising and aggregating actual risk data across around 175 firms in each area of the financial sector. This will provide it, and firms, with a much better picture about how cyber risk crystallises.

The Regulator acknowledges that the UK financial sector needs to build talent in the cyber security space and there is a lack of people entering the profession. The FCA supports the government initiatives to develop a cyber security profession.

Ms. Delfas concluded that the threat of cyber-crime continues to rise. Even the most mature organisations that are well funded and have good security capability cannot counter the threat in isolation. She stated that the financial services sector needs to collaborate better with other firms and the government to share intelligence and develop talent to keep the industry safe and secure in the future.

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

Enforcement Matters

FCA bans and fines two individuals for market abuse

7 April 2017

A former Chief Financial Officer and a former Financial Controller of a spread betting entity which used to be regulated until its collapse in 2012 have been fined a combined total of £116,900 and permanently banned from performing any function related to regulated activities. The case was pursued under the Market Abuse Regime whilst the FCA also considered the possibility of pursuing criminal charges for market misconduct.

The holding company of the firm was listed on the Alternative Investment Market of the London Stock Exchange in August 2007. The FCA found that the admission documentation for the floatation contained 'materially misleading information' and failed to include fundamental information which was necessary to enable investors to make an informed decision about the company. The CFO was instrumentally involved in preparing and approving the admission documentation for the floatation of the holding company and was also found by the FCA to have assisted in managing an undisclosed 'internal hedging' strategy at the spread betting firm which involved the unauthorised use of client trading accounts together with the use of fake accounts.

The Annual Accounts for the spread betting firm from 2010 to 2011 also contained misstatements with regards to shortfalls in the client money position which amounted to £15.9 million and was ultimately concealed from investors.

During this period the FCA found that the CFO and FC knowingly falsified key financial information concerning the firm's cash position and client liabilities. It was the inability to meet its client money obligation which consequently led to the firm's collapse in March 2012.

Mark Steward, FCA Director of Enforcement and Market Oversight, provided a clear statement condemning the behaviour of the two individuals stating that they had 'deliberately and repeatedly disseminated false and misleading information relating to a publicly listed company. Their actions amounted to serious market abuse, undermining the integrity of our markets and this will not be tolerated'.

The Final Notice was issued to both the CFO and FC on 7 April 2017 and each qualified for a 30% discount by agreeing to settle at an early stage. The CFO also showed financial hardship which led to a reduced fine of £11,900 as opposed to the potential £468,756, whilst the FC was fined £105,000 as opposed to a potential £150,000 fine.

If you would like to read the FCA notice, please click here.

Other publications

ESMA publishes updated AIFMD and UCITS Questions and Answers

7 April 2017

The European and Markets Authority (ESMA) has published updated questions and answers (Q&A) on the application of the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for the Collective Investment in Transferable Securities Directive (UCITS).

The purpose of these Q&A's is to highlight common supervisory approaches and practices of both the AIFMD and the UCITS Directives and their implementing measures.

If you would like to access the Q&A's, please click here.

ESMA - Securities Financing Transaction Regulation (SFTR)

Background

The regulation on reporting and transparency of securities financing transactions (SFTR) came into force on 12 January 2016.

Securities Financing Transactions (SFTs) are any transaction where securities (or commodities) are used to borrow cash or vice versa. This includes repurchase agreements (repos), securities and commodities lending and borrowing activities and sell/buy-back transactions. Additionally, margin lending transactions in relation to securities transactions are also explicitly within scope, including where these are entered under a prime brokerage arrangement, as well as the usage of total return swaps. Generally, the SFTRs will apply to all counterparties to an SFT that are established within the EU, including overseas branches of such entities.

The SFTR also explicitly applies to EEA authorised AIFMs and UCITS Management Companies, although there is some lack of clarity as to whether this applies where the counterparty itself is outside of the EU. This would be the case, for example, in relation to a Cayman domiciled AIF. It is expected that this will be clarified in due course through ESMA Q&A.

There are three main requirements associated with the SFTR that will be relevant in different ways to various clients:

Transparency for fund investors

The periodic reports issued by EEA authorised fund managers will now need to include transparency information relating to the usage of SFTs within the funds, which must be disclosed in line with the template in Section A of the Annex to the SFTR. For AIFs, this disclosure will be required annually in the Annual AIF Report to investors, and for UCITS funds this disclosure will be required in the half-yearly reports. This requirement became effective from 13 January 2017 and therefore these disclosures should be included in all AIF and UCITS reports going forward.

Additionally, disclosure will need to be made in the pre-contractual documents presented to prospective investors before they make their first investment (i.e. the fund prospectus). This requirement already applies for new funds, but for any fund that existed prior to 12 January 2016 there is a transitional period and firms have until 13 July 2017 to ensure that the pre-contractual documents have been updated to include this information. The template containing the required information for these disclosures can be found in Section B of the Annex to the SFTR.

Re-use of collateral/rehypothecation

The SFTR also places a one-sided obligation on any counterparty intending to re-use collateral provided to it. This requires that the re-using counterparty must ensure that the counterparty providing the collateral has provided its explicit consent to the re-use of the collateral, and that it must have been provided with full disclosure on the risks of such re-use. In addition, the re-use must be undertaken in accordance with the agreed collateral arrangement, and where relevant the financial instruments received must be transferred from the account of the providing counterparty.

These rules have been in force since 13 July 2016, and it is expected that they would primarily apply to prime brokers.

T+1 Reporting to a Trade Repository

The final element of the SFTR regulations is the requirement to report all SFT transactions to a Trade Repository on a T+1 basis. This will be a double-sided obligation, with both counterparties to each transaction being required to report, although it may be permissible for one of the two reporting counterparties to delegate this activity. These requirements are not yet in force and the implementation date has also not yet been fixed. ESMA issued its Final Report including the draft RTS and ITS to the European Commission on 31 March 2017. The European Commission will then need to endorse and adopt these final rules within a period of 3 months. From that date, the reporting requirement will come into force on a phased basis as follows:

- 12 months for MiFID investment firms and credit institutions
- 15 months for CCPS and central securities depositaries
- 18 months for UCITS, AIFs and other collective investment undertakings
- 21 months for non-financial counterparties

In parallel with the reporting requirement, there is also a more general record keeping requirement that states that counterparties to SFTs must keep records of all SFTs for a period of at least five years. It should be noted that unlike the reporting requirement, there is no transitional period for this record keeping requirement, which has been in force since 12 January 2016. Firms should therefore take immediate steps to identify and record all SFTs entered into, if they are not already doing so.

The full text of ESMA's final report on the technical standards under SFTR can be found here.

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