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Financial Regulation Monthly Breakfast Seminar

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Overview

- FCA CP18/37 and 18/38 - Product intervention for CFDs, binary options, and similar products
- FCA Occasional Paper 47 on tweet risk warnings
- Brexit, including the latest update on contractual continuity
- Financial crime and enforcement update
- An overview of key wholesale market regulatory focus areas, and important dates to note, in 2019

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FCA CP18/37 and 18/38 - Product intervention for CFDs, binary options, and similar products

Rob Moulton

FCA background - CFDs

- 2009 Financial Promotions and CFDs Thematic Review
- 2012 CASS review following Worldspreads failure
- 2014 Best Execution Thematic Review and fine
- 2016 Dear CEO letter on appropriateness
- 2018 Dear CEO letter on advice and management

ESMA’s previous proposals and FCA’s response

- Temporary product intervention powers
- Now on 3rd 3 month rollover
- FCA’s action
    - Make them permanent
    - Expand products
    - Prepare for Brexit

FCA's proposals – the key changes

- FCA has observed workarounds by firms
  - Opt-up to elective professionals
  - Encourage trading with non-EU affiliates
  - Invent or use new non-CFD products
- New definition of "Restricted Option"
  - In the money at point of sale
  - Value determined one-to-one with underlying asset
  - Value not significantly affected by time to expiry
- Change ESMA leverage limit from 5:1 to 30:1 for certain government bonds

Further FCA considerations on CFDs

- Consulting on applying similar measures to exchange traded futures and similar OTC products
  - Potential personal hedging exemption
- Other derivatives may get caught
  - “Products that have similar product features…and pose similar risks that we are unaware of”
- Sensitivity to impact within EEA
  - Consultations with other NCAs
  - (Apparently) detailed dialogue with Cyprus

Binary options

- Follows the ESMA ban
- But include, in addition, “securitised binary options” which are excluded by ESMA
    - Minimum duration 90 days
    - Prospectus
    - Do not expose the provider to market risk

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FCA Occasional Paper 47 on tweet risk warnings

Rob Moulton

FCA paper on risk warnings in tweets

- Covered 10 retail products
- Detailed analysis based on comprehensive fieldwork
- “For character-limited social media, standalone compliance reduces consumers’ information search and understanding of risks, ultimately leading them to choose less suitable products”
- Product information more important
- Standardised risk warnings make risks in dissimilar products seem similar

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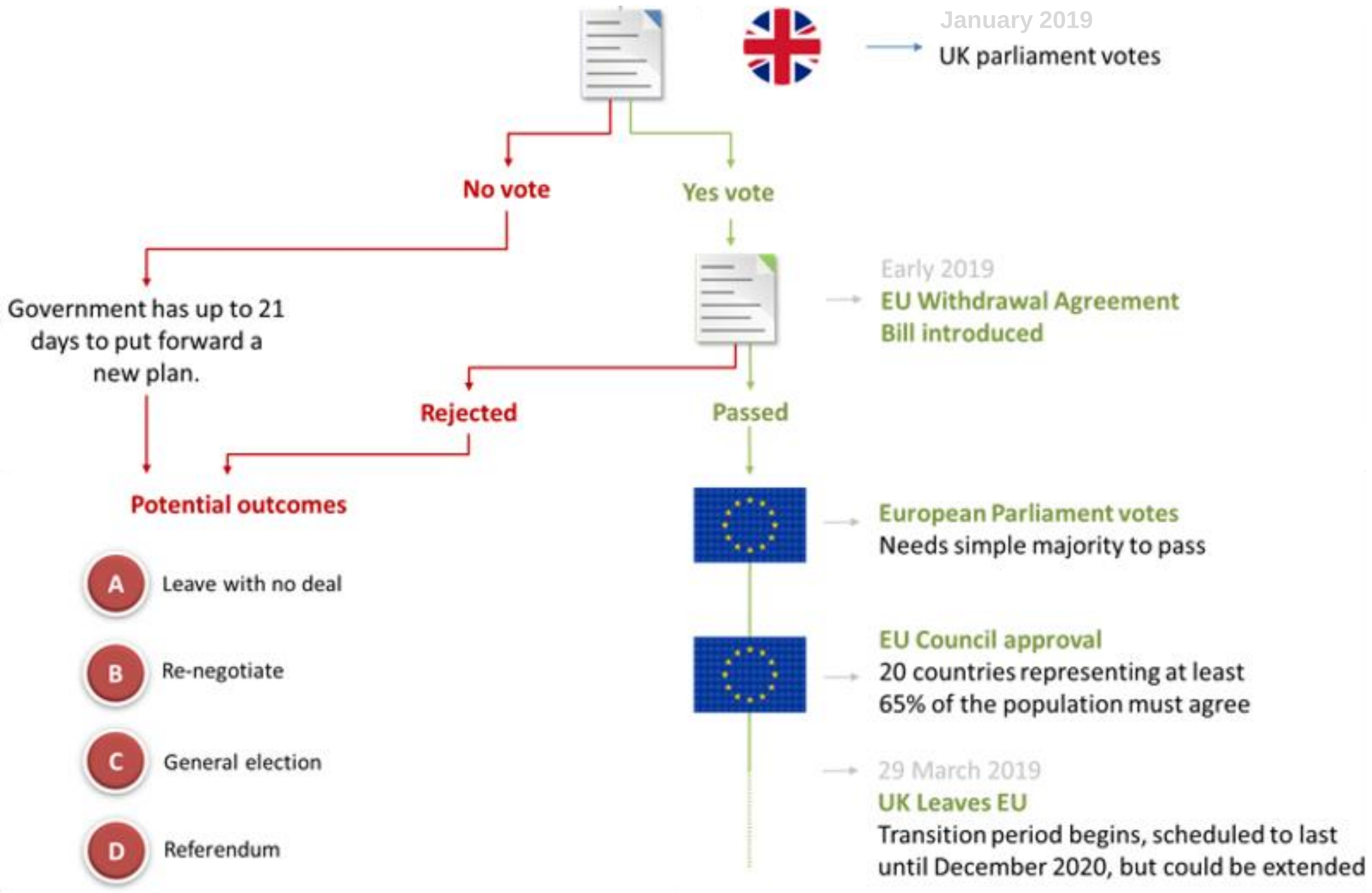
Brexit, including the latest update on contractual continuity

Anne Mainwaring

Potential next steps



Potential next steps (cont.)

- Section 13 EU (Withdrawal) Act 2018 provides that the Withdrawal Agreement may only be ratified if:
  - The relevant agreements have been published;
  - The negotiated Withdrawal Agreement and the Framework for the Future Relationship have been approved by a resolution of the House of Commons;
  - A motion for the House of Lords to take note of the negotiated Withdrawal Agreement and the Framework for the Future Relationship has been tabled in the House of Lords and the House of Lords has debated the motion; and
  - An Act of Parliament has been passed which contains provision for the implementation of the Withdrawal Agreement
- Current FCA approach

Contractual continuity

- The Government has published draft legislation for the financial services contracts regime (FSCR)
- Complementary to the temporary permissions regime
- The FSCR will ensure EEA firms passporting into the UK pre-exit that:
    - Fail to notify that they wish to enter the temporary permissions regime; or
    - Enter the temporary permissions regime but are unsuccessful in securing authorisation at the end of it;
- Are able to run off existing UK contracts in an orderly fashion

Contractual continuity (cont.)

- EEA firms within this regime will not be able to write new UK business – the regime is solely there to allow these firms to wind down their UK business in an orderly fashion
- The FSCR will automatically apply to EEA passporting firms that do not notify that they wish to enter the temporary permissions regime and will apply:
  - For 15 years for insurance contracts; and
  - For 5 years for all other contracts
- The FSCR will not apply to EEA funds marketed into the UK, or EEA managers of UK authorised funds
- EEA firms that wish to continue doing business in the UK after exit will need to enter the temporary permissions regime and obtain UK authorisation

Contractual continuity (cont.)

FCA CP19/2: Brexit and contractual continuity

- Distinguishes between “supervised run-off firms” (i.e. generally those having a place of business in the UK) and “contractual run-off” firms (i.e. those servicing clients on a cross-border basis pursuant to passport). The primary condition for both is that firms remain authorised in their home state
- SRO firms will be deemed to have Part 4A Permissions during the run-off period and will appear on the register. They will be subject to the same proposed rules as firms entering the temporary permissions regime, and subject to the full scope of FCA supervisory and enforcement powers
- CRO firms will only be subject to an *ad hoc* Special Project Fee, but otherwise not subject to FCA rules

UK vs EU approach

- UK approach to contractual continuity can be contrasted with that of the EU
- For example in relation to the treatment of OTC derivative contracts:
  - "Post-withdrawal, counterparties established in the United Kingdom will no longer be able to provide investment services in the EU under the current passport regime, so they might not be in a position to execute certain operations in relation to derivative contracts they have with EU clients, in particular certain so-called "life-cycle events" that can be construed in certain jurisdictions as the entering into new transactions (such as novations, unwinding by entering into an offsetting transaction, compression with new replacement contracts, etc.)…….In order to address this situation, these counterparties might have to novate their contracts to entities established and authorised in the EU, which would benefit from the single passport in financial services"

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Financial crime and enforcement update

Jon Holland

FATF mutual evaluation

- The UK
  - Has a robust understanding of the money laundering and terrorist financing risks to which it is subject
  - Proactively investigates, prosecutes, and convicts a range of money laundering and terrorist financing activity, securing approximately 1,400 convictions a year for money laundering offences
  - Has improved its legal framework since the 2007 evaluation by implementing the People with Significant Control (PSC) Register to aid enforcement agencies, regulators and businesses in identifying the ultimate beneficial owners of UK-incorporated companies
  - Ensures that all entities within the FATF definition of “financial institution” (e.g., banks and regulated investment firms) and “Designated Non-Financial Business Professionals” (e.g., lawyers and accountants) are subject to appropriate AML and CTF rules and are supervised for compliance with those rules

FATF mutual evaluation (cont.)

- But:
    - Levels of prosecution and conviction for “high end” money laundering do not appear to be consistent with the UK’s risk profile
    - The UK is not making taking full advantage of financial intelligence data
    - The SARs regime is not working
    - The regulatory regime is not working

FATF mutual evaluation (cont.)

- Action points for firms:
  - Ensure that risk assessments mandated under the Money Laundering Regulations 2017 have been performed, are documented, and are periodically updated
  - Review the National Crime Agency’s 2017 Guidance on submitting better quality SARs and consider reviewing internal policies and procedures associated with internal and external SARs
  - Be aware that the FCA placed particular emphasis on individual accountability within firms with regard to AML and CTF
  - Note that FATF recommended that the FCA consider wider use of criminal background checks for Approved Persons and Senior Managers
  - Be aware of pending changes to the PSC Register in January 2020

FCA updated Financial Crime Guide

- No seismic changes, but:
  - Increased emphasis on senior management responsibility / personal accountability
  - Increased reference to / consistency with EU publications and guidance
  - New section on insider dealing and market manipulation (consistent with wider trends – and see Market Watch 58)
- Not approved by HM Treasury; **only** the JMLSG Guidance Notes are approved by HM Treasury and therefore provide a potential safe harbour under the Money Laundering Regulations, so firms should have regard to the FCG **and** the Guidance Notes

FCA analysis of firms’ Financial Crime Returns

- Returns from larger FIs
- 550m customer relationships, including:
  - 120,000 PEPs
  - 1.6m other high risk customers
  - 1.25m customers connected to high risk jurisdictions
- 1.15m customers turned down for financial crime reasons; 375,000 existing customers exited for the same reason

FCA analysis of firms’ Financial Crime Returns (cont.)

- At least £650m being spent annually on tackling financial crime; probably a lot more
- 923,000 internal reports, including automated reports, of which:
    - 363,000 (40%) resulted in reports to the NCA
    - 2,100 resulted in reports of terrorism related suspicious activity
- Key risks
    - Identity fraud / phishing / computer hacking and malware – all increasing
    - Loan repayment / mortgage / application frauds

FCA Market Watch 58

- FCA's findings on industry implementation of MAR
    - Compliance is "a state of mind", not adherence to a set of prescriptive requirements
    - Requires "strong judgment" and flexibility, recognising that manipulative behaviours come in many guises
    - Many firms have a good understanding of their obligations and have configured their systems and controls accordingly; others are struggling
    - FCA expects firms to be fully compliant with the obligation to undertake quote surveillance

FCA Market Watch 58 (cont.)

- FCA's findings on industry implementation of MAR (cont.)
  - The obligation to file suspicious transaction and order reports (STORs) covers all relevant asset classes, not just equities; well over 70% of STORs currently relate to equities
  - The market soundings regime has not reduced appetite to initiate soundings; but reminders about rules on wall crossing; record keeping; and cleansing
  - Reminders about the importance of insider lists; lists received by the FCA were of "variable quality"; permanent insider lists can be helpful, provided the list is not disproportionately large

FCA Market Watch 58 (cont.)

- FCA has observed recent behaviour in the CDS market that appears to involve intentional, or “manufactured” credit events; any such behaviour, by counterparties or referenced entities is likely on the wrong side of the line and may constitute market abuse; no direct impact in the UK so far, but the FCA is watching and will take action

FCA / Sonali Bank - background

- Easier to identify what Sonali Bank got wrong in terms of AML compliance than what it got right
- Essentially **everything** was broken

FCA / Sonali Bank - first FCA involvement

- October 2016 – Final Notice against Sonali Bank (and MLRO)
- Breach of Principle 3 (failure to organise affairs responsibly and effectively)
- Sanctions:
  - Penalty of £3.25m
  - Restrictions on accepting deposits
  - MLRO – penalty of £17,900 and prohibition order

FCA / Sonali Bank - second FCA involvement

- December 2018 Final Notice against Sonali Bank CEO
- Breach of Principle 6 (failure to exercise due skill, care and diligence) and knowing involvement in Sonali Bank's breach of Principle 3
- Sanction:
  - Penalty of £76,400
- Referred to Upper Tribunal

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An overview of key wholesale market regulatory focus areas, and important dates to note, in 2019

Carl Fernandes

Key dates and focus areas for whole markets

1. <u>Brexit</u>
    - 15 January: Parliament votes
    - Q1: onshoring consultations complete and final rules published
    - 29 March: UK leaves the EU
    - Post 29 March: continued assessment of interdependencies between EU and UK vehicles and anomalies in regulatory positions

2. <u>MiFID 2</u>
    - 3 January: annual aggregated costs and charges disclosures begin
    - 1 March: mandatory SI regime for derivatives, securitised derivatives, ETCs, ETNs, SFPs and emission allowances
    - Q1: ESMA response to call for evidence on periodic auctions
    - H1: FCA response to thematic review on research pricing?

Key dates and focus areas for whole markets (cont.)

3. Benchmark reform
    - Q1: possible feedback from PRA/FCA on responses to Dear CEO letter in September 2018
    - 31 December: end of transitional period for administrators to get licensed
    - Ongoing: work to develop alternative risk-free rates to replace LIBOR
    - End 2021: possible end of LIBOR

4. MAR
    - Q1: Approach to Market Integrity consultation document
    - Ongoing: following MW 58, FCA to “continue to work closely with market participants to ensure a consistent, effective implementation of MAR”
    - Ongoing: potential enforcement action arising from above…

Key dates and focus areas for whole markets (cont.)

5. Derivatives Market reform
    - Q1: EMIR Refit proposals to be passed?
    - 9 May, 21 June, 9 August: continued phase in of clearing obligation
    - 1 September: initial margin requirements for Phase 4 entities
6. Financial Crime
    - Q1: HMT to consult on gold plating MLD 5
    - H1?: FCA findings on thematic review of harm caused by money laundering in capital markets
    - November: next annual publication of FCA analysis of financial crime returns
7. Competition
    - H1?: FCA PS on further remedies under AM market study
    - Possible enforcement action?

Key dates and focus areas for whole markets (cont.)

8. Governance, Risk Management and Accountability
    - Q1: final rules on proposed new Directory
    - Pre-9 December: final position re head of legal and scope of client dealing function under the SMCR
    - 9 December: extended SMCR to take effect
    - Potential follow up to the FCA's "transforming culture" initiative
9. Operational resilience
    - H1?: feedback on BoE/PRA/FCA DP on building operational resilience in the UK financial sector
    - 30 June: new EBA outsourcing guidelines to take effect
10. Fintech
    - Q1: follow up to UK Cryptoassets Taskforce final report (consultations on perimeter and also proposed restrictions on selling crypto-derivatives to retail clients)

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Questions?