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Financial Regulation Monthly Breakfast Seminar

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Overview

- The expiry of equivalence under MiFID II for Swiss trading venues, the Swiss response, and the market's reaction
- The FCA's retail client protection rules on CFDs, and consultation on banning products referencing cryptoassets
- Findings from FCA's Thematic Review on money laundering risks in capital markets
- FCA CP19/20 on assessing the adequacy of financial resources in FCA-regulated firms

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The expiry of equivalence under MiFID II for Swiss trading venues, the Swiss response, and the market's reaction

Anne Mainwaring

The MiFID II share trading obligation - expiry of equivalence for Swiss trading venues

- The MiFID II share trading obligation means that investment firms can only trade shares subject to the STO on an EU venue, an EU SI or a third country trading venue that has been assessed as equivalent by the European Commission
- The European Commission had recognised certain Swiss trading venues as equivalent for a temporary period
- This temporary period expired on 30 June 2019

Expiry of Swiss equivalence – what does this mean?

- The expiry of the equivalence decision means that EU firms, from 1 July, are no longer able to trade shares subject to the STO on Swiss trading venues
- This is particularly problematic for Swiss shares that are admitted to trading or traded on an EU trading venue on a frequent and systematic basis

The Swiss response

- Switzerland introduced the Ordinance on the Recognition of Foreign Trading Venues for the Trading of Equity Securities of Companies with Registered Office in Switzerland in 2018
- This introduced a recognition obligation for foreign trading venues that admit Swiss companies' shares to trading

The Swiss response

- Following the non-renewal of Swiss equivalence for the purposes of the STO by the European Commission, Switzerland withdrew the recognition of EU trading venues under the Ordinance
- EU venues have therefore had to suspend or de-list Swiss shares as these can no longer be traded on EU trading venues

Where does this leave us?

- Where shares are delisted or suspended from trading on an EU trading venue and are therefore not traded on a systematic and frequent basis in the EU then the STO will not apply
- Where this is not the case this may pose operational challenges and potentially reduced available liquidity
- FCA approach – will look at the specific circumstances, in particular that firms have acted in the interests of clients by seeking best execution
- Market practice post 1 July

Practical impacts

- Still need to search FIRDS
- Also consider impact on trade and transaction reporting

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The FCA's retail client protection rules on CFDs, and CP on banning products referencing cryptoassets

Rob Moulton

CFD restriction

- PS19/18 which largely confirms CP18/38
- Restrictions on leverage and mandatory risk warnings
- Applies to CFDs and CFD-like options
  - In the money at point of sale
  - Value determined one-to-one
  - Value not significantly affected by time to expiry
- ESMA’s temporary product intervention
  - Being allowed to lapse

Scope changes / confirmations / clarifications

- Change – only applies to leveraged CFDs (e.g. not IRS)
- Clarification – "structured products are not the focus of our intervention"
  - Still a case by case assessment
- Confirmation – definition of restricted options unchanged
- Clarification – SCARPs are out of scope
- Clarification – warrants are out of scope
- Confirmation – constant leverage certificates are in scope
- Change – sales intermediated by non-UK firms out of scope

Scope changes / confirmations / clarifications

- Clarification – provision of support services from UK is out of scope
- Confirmation – does not prevent dealing by non-UK EEA firms on a reverse solicitation basis
- Confirmation – leverage limit for CFDs referencing certain government bonds will be 5:1 (ESMA – 30:1)
- Clarification – ban on offering benefits to retail clients does not catch tiered volume fee discounts
- Confirmation – risk warning wording (slightly different to ESMA)

ESMA’s opinion and FCA’s response

- Agrees measures are proportionate and justified except
  - The scope of the ban on reverse solicited dealing should be expanded to include non-UK EEA
  - The 5:1 leverage for certain government bonds which should be 30:1
  - AMF criticised the FCA for an un-level playing field
- The FCA’s response
  - We are right
  - We don’t care

Derivatives referencing cryptoassets – policy proposals

- Ban on sale, marketing and distribution of derivatives and ETNs referencing unregulated transferable cryptoassets ("crypto derivatives")
- Key justifications
  - Inability reliably to value the underlying cryptoasset
  - Risks from financial crime
  - Extreme volatility (comparisons with gold, nickel, orange juice, lean hogs)
  - Lack of retail understanding

Scope

- CFDs, futures, options that reference cryptoassets
  - Referencing includes benchmarks as well as single assets
- ETNs whose returns track cryptoasset values
- Must reference unregulated assets that can be transferred
- Ban includes other EEA firms including on a reverse solicitation basis
  - But not third country firms

Definition of unregulated transferable cryptoasset

- A cryptographically secured digital representation of value or contractual rights that uses distributed ledger technology and which
  - Is capable of being traded on or transferred through any platform or other forum
  - Is not limited to being transferred to its issuer in exchange for a good or service, or to an operator of a network that facilitates its exchange for a good or service
  - Is not electronic money
  - Is not a specified investment

Out of scope

- Tokens that are not widely transferable
  - E.g. can only be redeemed with the issuer
- E-money tokens
- Derivatives that reference security tokens (as they are securities, a regulated asset class)
- QIS or AIFs
  - Mainstream retail protections already apply
- Professionals and Eligible Counterparties

Other observations

- The FCA reminds firms of their general duties
  - Inappropriate opt-ups
  - Clients best interest rule
  - Product governance
  - International work ongoing to prevent circumvention
- Rule does not apply in other EEA states that are subject to stricter requirements

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Findings from FCA's Thematic Review on money laundering risks in capital markets

Jon Holland

Background

- AML compliance is a recurrent theme – and likely to remain so following the FATF Mutual Evaluation of the UK in 2018
- TR19/4 is based on diagnostic visits to 19 firms (investment banks, investment exchanges, custodians, clearing and settlement houses, inter-dealer brokers and trading firms – plus trade bodies)
- There is (considerable) room for improvement in terms of recognising and understanding money laundering risks; Thematic Reviews are typically precursors to enforcement *pour encourager les autres*

Key points

- All asset classes present some AML risk
- **Effective** CDD – including understanding a customer's trading strategy – given the complexity of capital markets transactions; one weak link in the chain can be fatal; no party in the chain is "more" responsible for AML compliance than another party
- Reliance on others is permitted in some situations – but the buck stops with the firm relying on a third party, not the third party
- CDD is an on-going obligation

Key points

- Transaction monitoring (including contextual monitoring to reduce false positives) is also key; automated and manual monitoring works better than fully automated monitoring; raising awareness of AML risk in the front office is better yet
- Market abuse and money laundering don't come from Mars and Venus respectively; coordination between the surveillance and AML functions is crucial – but isn't happening in every case
- Monitoring the front office is important; there are still some naughty traders out there

Key points

- STORs and SARs aren't mutually exclusive; on the contrary, in many cases it will be necessary to file both; lots of firms have got into a muddle about this
- Where firms are filing SARs, they're of variable quality
- AML is not only a back office issue; the front office needs to take its responsibilities seriously; attestations can be a good way of holding people's feet to the fire
- The primary market is not immune from AML risk
- Someone senior will be accountable for AML failings under SMCR

Take aways

- Apply lessons from TR19/4, including the typologies in the Annex
- Although TR19/4 is about the capital markets, some of the lessons (eg misunderstandings in relation to STORs and SARs) are applpicable across the board

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FCA CP19/20 on assessing the adequacy of financial resources in FCA-regulated firms

Carl Fernandes

Background and context

- Builds off the FCA's Approach to Supervision document
- Some 30,000 firms are not subject to detailed prudential requirements, do not need to prepare an ICAAP and are only subject to Threshold Condition 2.4 (requiring firms to have adequate resources, including financial resources) and Principle 4 (maintaining adequate financial resources)
- Purpose of the CP is:
  - To improve the way these firms assess and manage risk, and hold capital and liquidity to manage the risks both on going and gone concern basis
  - Not to increase overall levels of financial resources across the industry
  - Ultimately to reduce disorderly failure and reliance on FSCS payouts, and to reduce the levy
- Responses due by 13 September

FCA’s general expectations of firms

- An assessment of risk that is **proportionate** to the nature, scale and complexity of the business; is appropriately **forward-looking** (3 years) to see how the risks evolve through the business cycle, and happens at **least annually**
- An understanding of the **vulnerabilities in the business model**, and how changes in operational and economic circumstances might impact the ability to generate acceptable returns
- A focus on the **prevention of harm** to consumers and markets
- Putting things right when they go wrong – including consumer redress
- **Minimising harm in failure**, including orderly wind-down

Reducing harm: capital and liquidity

- Capital is basically **equity** and **loss-absorbing debt**
- The value of capital is **not static** – changes to the value of assets and liabilities which are not otherwise compensated, impacts the accounting value of capital
- Capital is needed for **unexpected losses** arising in **adverse circumstances**, including consumer compensation, enforcement fines, and direct and indirect litigation costs
- Appropriately **liquid resources** to take into account
    - Ability to monetise quickly and without loss in value
    - Appropriate diversification
    - Currency convertibility
    - Transferability of funds intra-group

Reducing harm: systems and controls, governance and culture

- "Firm **culture** shapes the **outcomes** for consumers and financial markets. The drivers of culture, including governance, within firms should encourage behaviours that prevent harm"
- Drivers of culture
  - Purpose
  - Attitude, behaviour and competence of leadership
  - Approach to managing and rewarding people
  - Governance, controls and processes
- Firms must identify and understand the risks that arise from their activities, and should have a clear and quantified **risk appetite** in relation to these risks which is communicated, understood and followed across the firm

Reducing harm: identifying and assessing risk of harm

- Firms are expected to **identify all significant harms** related to the activities they undertake, e.g.:
  - Platforms and custody firms may be affected by system outages causing disruption to continuity of service and customers accessing/seeing value of assets
  - Financial advisors may provide unsuitable advice resulting in loss
  - Corporate finance firms may fail to undertake appropriate due diligence
  - Principal trading firms may cause market disruption via errors in their trading systems (e.g. rogue algorithms)
- Firms must assess the **likelihood and impact** of things going wrong. Using knowledge and experience to inform statistical models where possible, firms should assess the residual risk after the impact of controls. Firms should also factor in the impact of wider operational and market conditions on financial resources – e.g. stress testing

Reducing harm: sustainability of business model

- An important part of a risk assessment is to understand the key components of a firm's business model and strategy, including:
  - Details of profitability of each business line, and how this has evolved
  - External factors influencing success
  - Reliance on franchise and reputation for success
  - Competitive advantages over peers
- FCA expects firms to consider forward-looking financial projections and strategic plans, under both business-as-usual and severe (but plausible) adverse circumstances that are outside their normal and direct control. This helps a firm to understand the risks to viability of its business model and the sustainability of its strategy over a period of at least 3 years

Reducing harm: wind-down planning

- Wind-down plans need to be **credible** and have **realistic timescales** and assessments of how financial and non-financial resources are maintained while the firm exits the market
- **Qualitative assessment**: assessment of key staff and systems, intra-group dependencies, client communications, CASS resolution pack, replacement providers for clients
- **Quantitative assessment**: points to note
  - 9 months is more realistic wind-down period
  - Consider extra closure costs, e.g. penalties for early termination, advisor costs
  - Potential redress and litigation
  - Tail off in revenues and collections
  - Drop in realisable value of assets

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Questions?
12h
:30