

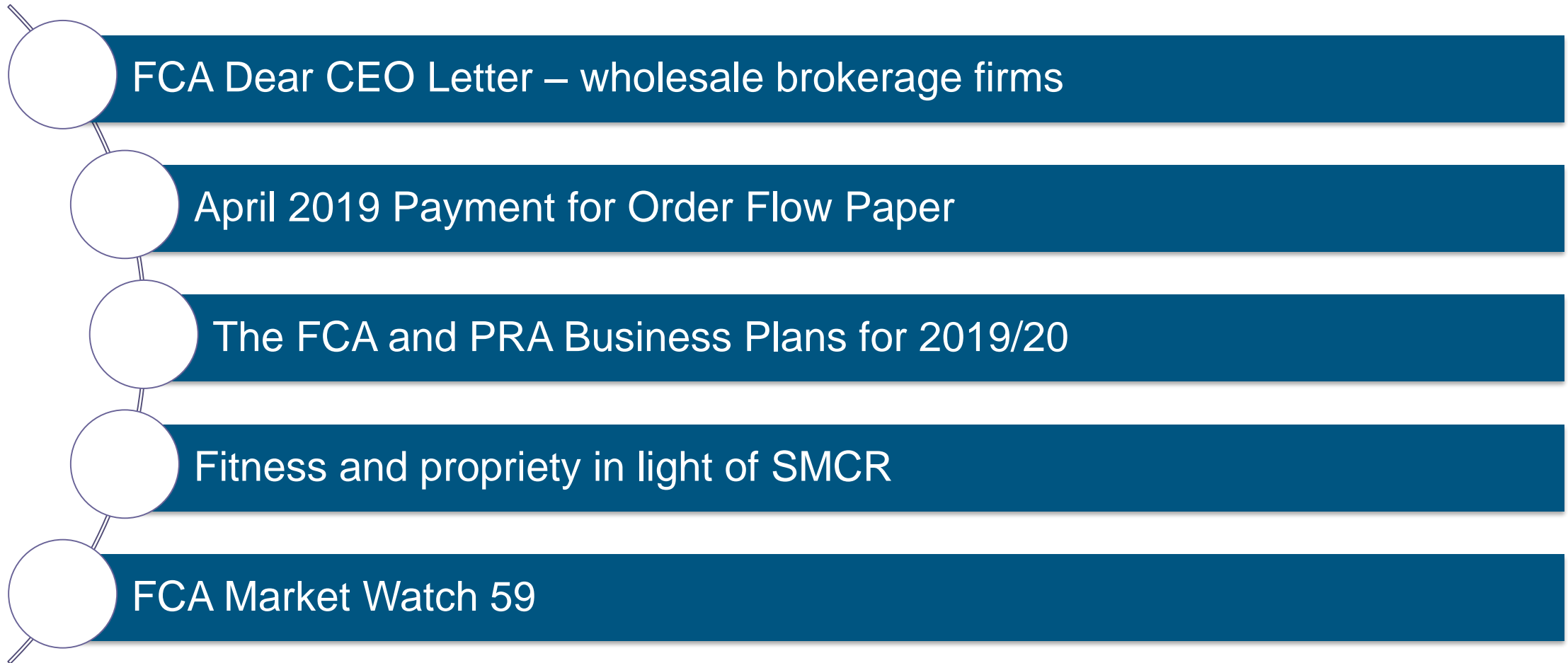


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8 May 2019

Financial Regulation Monthly Breakfast Seminar

Overview





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FCA Dear CEO Letter – wholesale brokerage firms
Rob Moulton

Application and high-level views

- Who is the letter really addressed to?
 - “Brokerage firms operating in wholesale financial markets”
 - “Firms sourcing liquidity and discovering prices, and bringing together buyers and sellers...[with] broker discretion at its centre”
 - “Large and small brokerage firms”
- Strong criticisms
 - “Less progress than other sectors in embedding a culture of good conduct”
 - “Unlike other types of firms in these markets, brokers have not kept pace with, and have under-invested in, the requirements of this new legislative and regulatory environment [MiFID II and MAR]”
 - “Complacent attitude and resultant failure to meet expectations across all the areas of regulation we have recently examined”

Specific criticisms

- Compensation and incentives
 - Criticism of the “common remuneration model, which involves frequent, formulaic cash payments to individual brokers based on revenue”
 - Ongoing survey of 50 firms, FCA will publish findings later this year
- Governance and culture
 - Individual brokers are often principal revenue earners
 - Stronger governance needed (in particular in the context of SMCR)
 - Criticism of poorly designed PA dealing practices
- Technology
 - “Serious deficiencies in resilience and readiness to combat cyber-crime”
- EU withdrawal
 - Plans should allow firms to act in the best interests of clients

Additional follow-up steps

- Must consider and discuss the letter with the management board
- FCA may write to firms again after March 2021 to give an updated view following further ongoing work



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April 2019 Payment for Order Flow Paper
Rob Moulton

Background and key observations

- Follows up on numerous other papers dating back to 2012
 - These described PFOF as a payment from a broker to a market maker
- Unlike previous papers, FCA re-defines when the PFOF rules apply
 - “PFOF occurs when an investment firm (**typically** a broker) that sources liquidity and executes orders for its clients receives a fee/commission from both the client that originates the order and the **counterparty** the trade is then executed with (**typically** a market maker **or other liquidity provider**)”
- Listed derivatives remain the core focus, but PFOF applies across all financial instruments

FCA's analysis

- Important distinction between sourcing exclusive liquidity, and non-exclusive liquidity
 - Are you actually acting for a single party or not?
 - Where so, firms should not charge any liquidity provider
 - Implication for capital markets?
- FCA's non-permitted workarounds
 - Not charging PFOF to exchange-registered market makers, but continuing to charge it to other types of liquidity provider such as a bank
 - Charging liquidity providers if the broker conducted negotiations with it
 - Presenting liquidity providers with client bids or offers to argue that the liquidity providers were taking, not providing, liquidity
 - The use of service charges
 - Routing orders to non-UK brokers to avoid PFOF

Inter-dealer brokers

- 2012 paper had said that the PFOF rules did not apply to firms who were acting as inter-dealer brokers
- 2019 paper says there is no “general exemption for inter-dealer brokers”
- Payments can still amount to PFOF if a client is relying on the broker to act on its behalf, such as by providing exclusive liquidity
- Managing the conflict of interest that arises from dual-sided charging requires a broker to be:
 - Sourcing liquidity and distributing it broadly
 - Ensuring clients have a reasonable opportunity (adequate time) to interact
 - No right of first refusal to any specific client
 - Use of systems and controls to ensure it is genuinely acting in this capacity and has policies and procedures to manage the conflicts

Management of conflicts of interest

- FCA identifies the use of unwritten rules and protocols on the trading floor
- FCA “expects firms that provide broadly disseminated non-exclusive liquidity to formally codify within their written conflicts of interest policy any unwritten rules and protocols”
- FCA not satisfied that manual sampling carried out by most firms was sufficient
 - In particular in the voice broking market
 - Firms would “generally sample less than 1% of their total transactions”
 - Good practice is to scrutinise commissions applied to counterparties that typically act as liquidity providers (note the expanded definition)



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The FCA and PRA Business Plans for 2019/20
Carl Fernandes

Things to note

- The plans are a useful annual cross-check on priorities we are already aware of, and a heads-up on new priorities
- We have focused on new/interesting points in wholesale markets*
- A key theme is assessing how to meet the regulatory objectives in the face of change:
 - Technological change
 - Geopolitical/Global change – i.e. Brexit
 - Changes in public expectations/interest
- The FCA's annual budget for 2019/2020 is £558.5m, up £14.6m from prior year
- The PRA's annual budget for 2019/2020 is £273m, down £1m from prior year

FCA Cross-sector priorities

- Current priorities
 1. Brexit* - “most significant change affecting financial services markets”
- Continuing priorities
 2. Culture & Governance*
 - Explore themes of purpose, leadership and management capabilities, remuneration and incentives, and firms’ assessment of culture
 - “we expect firms to demonstrate awareness of our expectations on culture, reflect this in their practices, and make specific improvements ...”
 3. Operational resilience*
 - Will publish a response to Operational Resilience DP (with PRA) in Q3 – focus on resilience/reaction to cyber-attack, assessing third party providers, change management; supervisory work to score firms
 4. Financial Crime*
 5. Fair treatment of existing customers

FCA Cross-sector priorities cont'd.

- Strategic challenges

- 6. Innovation, data and data ethics*

- Call for evidence on data use/access in wholesale markets
 - Finalise perimeter guidance on crypto-assets; provide technical advice to HMT on extending the perimeter for utility and exchange tokens
 - RegTech to focus on data exchange between industry and regulators, and cost-efficient AML/financial crime surveillance

- 7. Demographic changes

- 8. The future of regulation*

- Assist HMT on development of future regulatory framework and access arrangements with new markets
 - To publish an annual statement on the perimeter – identifying gaps
 - Further work on duty of care (FS 19/2 – no statutory duty, but perhaps changes to FCA principles and way they are policed)

FCA Sector-specific priorities

1. Investment management*
 - Evaluate responses to DP on stewardship
 - PRIIPs and product governance
2. Retail lending
3. Pensions and retirement income
4. Retail investments
5. Retail banking
6. General insurance and protection
7. Wholesale financial markets*
 - Market abuse surveillance in fixed income markets
 - Widen supervision of LIBOR transition risks
 - More work on MiFID II conflicts management (e.g. PFOF)

PRA priorities

- See post-crisis reforms slowing, and now a shift to supervisory BAU
- Ring-fencing: “after many years of hard construction work the fence is up, and our activity switches from building to border patrol ...”
- Governance and accountability: “we will begin an evaluation of the effectiveness of SM&CR and remuneration policies ...”
- Operational Resilience – “aim to establish a stronger regulatory framework in this area”
- Increased expectations of firms to identify and manage financial risks arising from climate change
- Continued support for the licensing of new banks and new insurers



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Fitness and propriety in light of SMCR
David Berman

Fitness and propriety standards and framework

The Fit & Proper “pillars” – no change per se

- Honesty, integrity and reputation
- Competence and capability
- Financial soundness

Some illustrative examples

- See FIT 2
- Banking Standards Board’s Supporting Guidance to Statement of Good Practice 1 offers suggested definitions of the 3 pillars

Note: FCA’s recently published views on the relevance of non-financial misconduct

Fitness and propriety monitoring and assessments

- When to conduct an F&P assessment

Onboarding

When joining the firm or taking on a new role within the firm

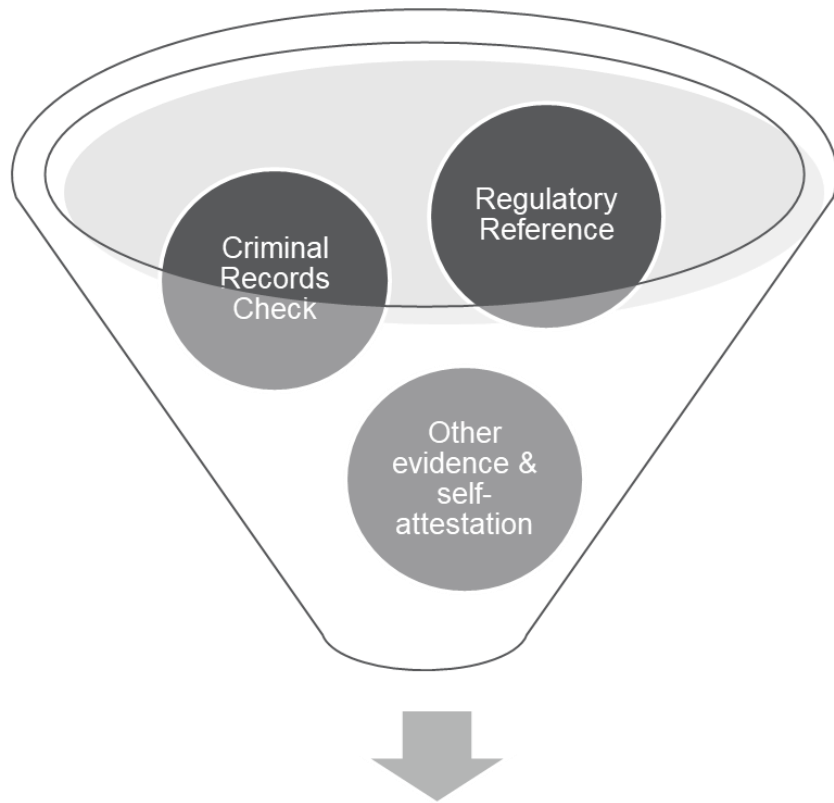
Annually

Part of the required annual assessment

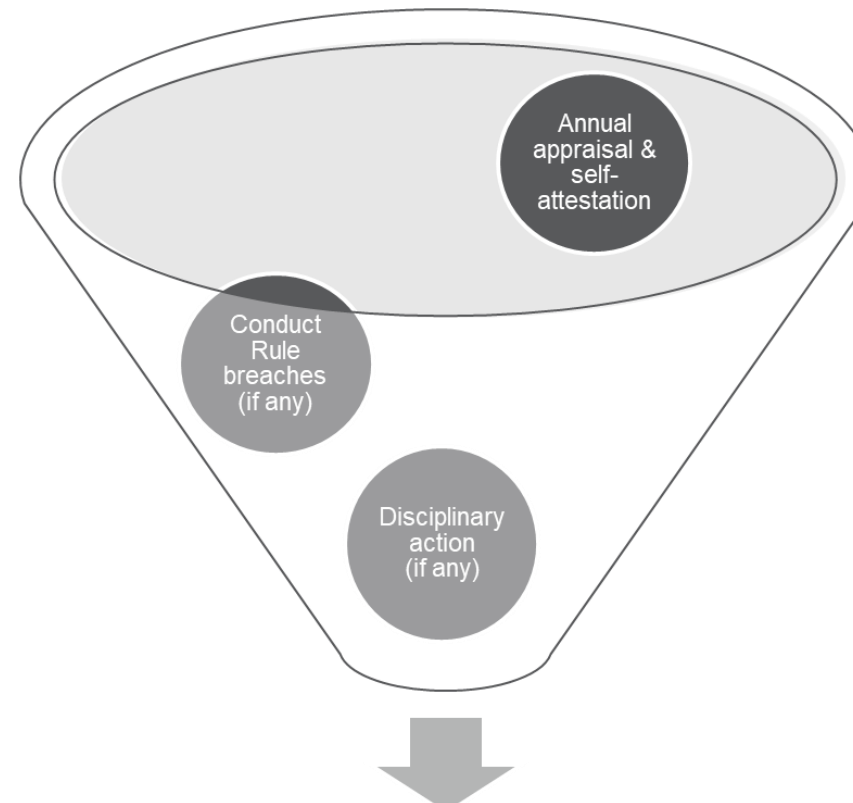
Ad hoc

When there is a “trigger event” such as the outcome of disciplinary proceedings

Fitness and propriety monitoring and assessments



Initial F&P assessment



Ongoing F&P assessment

Fitness and propriety monitoring and assessments

Notification obligations

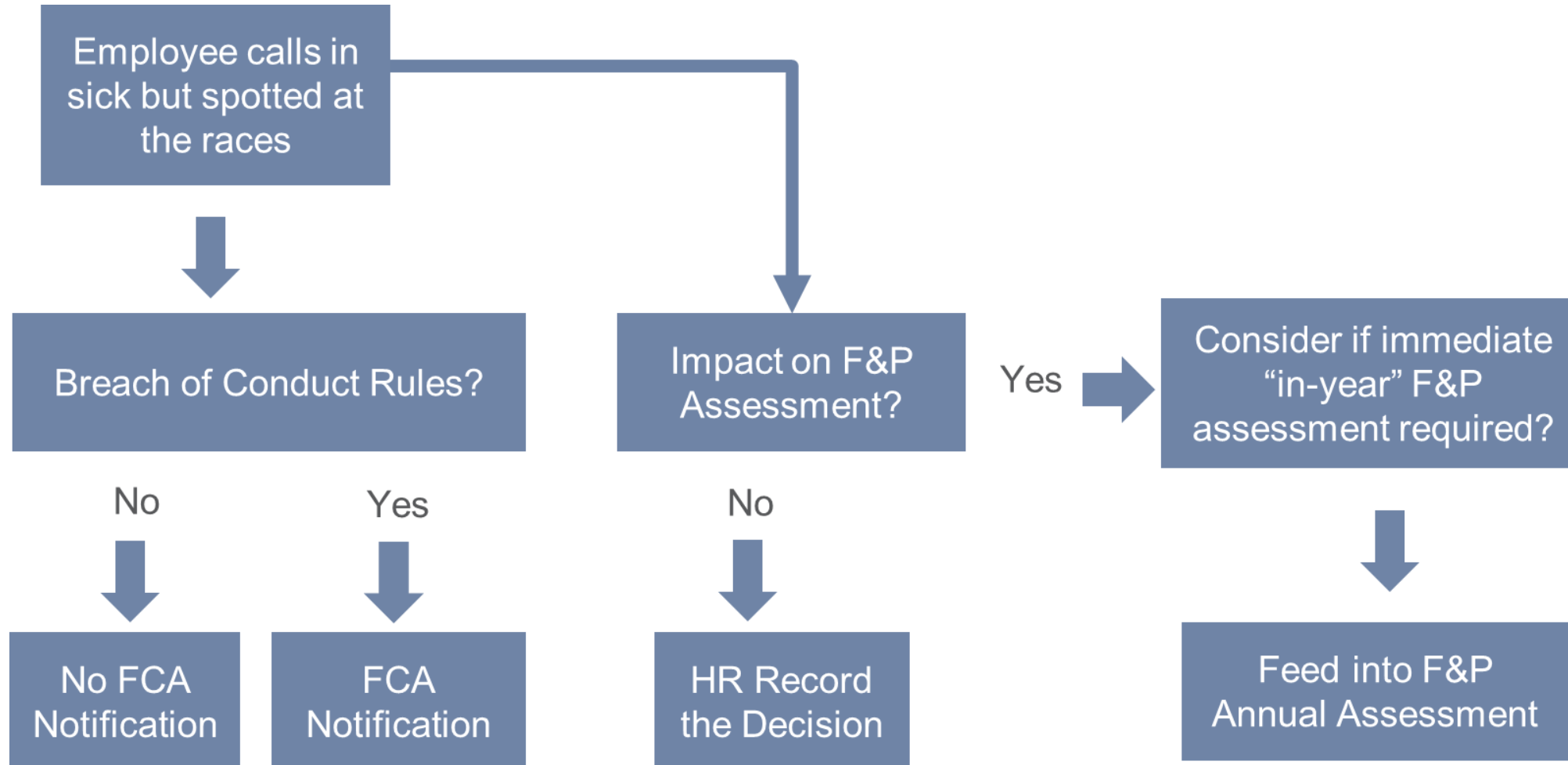
- A firm is required to notify the FCA (as soon as practicable – ideally, within 1 business day of the firm becoming aware) if it intends to submit a qualified Form C – which circumstances include the firm having information which reasonably suggests that it may affect the FCA's assessment of a Senior Manager's F&P (SUP 10C.14.7R(2)(c))
- If a firm becomes aware of information which would reasonably be material to the assessment of the fitness and propriety of a Senior Manager, it must inform the FCA as soon as practicable and, in any case, within seven business days (SUP 10C.14.18R)

Fitness and propriety monitoring and assessments

Notification obligations

- Firms have an obligation to notify the FCA when they take disciplinary action as a result of a breach of the Conduct Rules (Section 63C FSMA) – the timing of the notification differs depending on whether the action concerns a Senior Manager or Certified Person (annually)
- Firms will also need to consider whether they need to make a notification under Principle 11
- If an investigation reveals an issue that also relates to individuals who have left the firm, the firm must consider whether it needs to update any regulatory references it has previously provided

Worked example – disciplinarys and F&P



Some common questions / issues

- Who should perform an F&P assessment?
- Coordination is key (especially between Compliance and HR)
- Importance of consistency across:
 - FCA forms submitted
 - Regulatory references
 - FCA notifications
 - Any relevant public statements
- Alignment with existing processes (e.g. disciplinary and appraisal)
- Need to avoid any potential for bias / conflicts of interest

Practicalities

- F&P policy / protocol
 - Consistency (pass / fail criteria)
 - Comprehensiveness of data feeds (must cover all 3 pillars)
 - Guidance on significance
 - In-year assessment triggers
 - Legislating for grey / difficult scenarios (escalation process, appeals)
- Periodic assessor training
- Internal Audit F&P framework effectiveness reviews
- Use of self-attestations
 - Scope of coverage
- On-going monitoring of Certified Person population – must remain up-to-date

Useful reference guides

- Banking Standards Board (BSB): Statement of Good Practice 1 (28 February 2017)
- BSB: Supporting Guidance to Statement of Good Practice 1 (28 February 2017)
- BSB: Supporting Guidance to Statement of Good Practice 1 (20 February 2018)



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FCA Market Watch 59
Becky Critchley

FCA's Market Watch 59

- Systems and controls
 - Regular reconciliations
- Reporting trade time, price, and venue
 - Time stamping
 - Currency
- Party identifiers
 - Buyer / seller inverted
- Instrument reference data
 - ISINs
- Errors and omissions
 - Failure to cancel, correct and resubmit
 - Failure to notify the FCA

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Questions?