

A blue-toned background featuring a financial line chart with multiple data series and a grid. The chart shows various trends, including a sharp decline followed by a recovery and another decline.

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11 April 2018

# Financial Regulation Monthly Breakfast Seminar

# Overview

- 
- EU regulatory developments
  - FCA and PRA Business Plans
  - FCA's Asset Management Market Study
  - FCA's proposed new Financial Crime Systems and Controls guidance
  - FCA's discussion paper on transforming culture



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# EU regulatory developments

Rob Moulton, Axel Schiemann and  
Markus Krüger

# MiFID II – ESMA’s research Q&A

## Updated ESMA Q&A on investor protection and intermediaries topics

- Background: research / material made “*openly available*” may qualify as an acceptable minor non-monetary benefit, meaning buy-side firms do not have to pay for it from their own resources or from a research payment account
- Development: “ESMA considers that ‘*openly available*’ in the context of written material should mean that there are no conditions or barriers to accessing it, for example a necessary log-in or sign-up, or the submission of user information by a firm or a member of the public, in order to access material” (ESMA Q&A 8 on Inducements (Research))
- Impact on professional-only research?

# Corporate access

- Still a hot topic, without a settled view
- ESMA's (2017) Q&A
  - Cannot be research
  - Cannot be subsidised by research charges
  - Could be a non-monetary benefit which needs to be paid for – more likely if one-on-one or field trip, unlikely if the bank is acting for the corporate
- What about if the bank is pitching to the corporate?
- Where is the true risk – buy or sell side?

# ESMA product intervention on CFDs and binary options

- 15 December press release – “ESMA will conduct a brief public consultation in January 2018 on this matter”
- 18 January Call for Evidence
- 27 March 2018 press release – “ESMA agrees to prohibit binary options and restrict CFDs to protect retail investors”
- ESMA’s key considerations
  - “Complexity and poor transparency” of CFDs
  - Application of leverage
  - Marketing and distribution activities

# Agreed Measures

- CFDs agreed measures:
  - Leverage limits (30:1 major currencies, 5:1 individual equities, 2:1 or a prohibition on cryptocurrencies)
  - Margin close-out rule (50% of margin, which halves the above limits)
  - Negative balance protection
  - Restriction on financial and non-financial incentives
  - Standardised risk warning
- Binary options agreed measures:
  - Prohibition on the marketing, distribution or sale of binary options to retail investors
- Applicability
  - CFDs: two months after publication in Official Journal of the EU
  - Binary options: one month after publication in Official Journal of the EU
  - Applicability limited to three months (Art. 40 MiFIR); potential renewal thereafter

# Brexit – UK Analysis

- Transitional Agreement – in principle
  - Retains single market until 31 December 2020
  - What can go wrong now?
- FCA / PRA / BoE reactions
  - Comfort for incoming businesses
  - Confidence for outbound passported businesses
- FCA January Board Minutes confirm a mini-moratorium on new rules / policy; reflected in the FCA Business Plan

# Brexit – PRA’s view

*“The foundation to our approach to preparations for EU withdrawal remains the presumption that there will be a high degree of supervisory co-operation between the UK and the EU. In March 2018, we welcomed the agreement at the EU Council for a transition period until the end of 2020 as part of the UK’s withdrawal agreement with the EU, and published the final policy alongside a letter to firms outlining our approach to authorisation. This approach takes account of the Government’s commitment to bring forward legislation, if necessary, to create temporary permission regimes to allow relevant firms to continue their activities in the United Kingdom for a limited period after withdrawal. In the unlikely event that the Withdrawal Agreement is not ratified, this provides confidence that a back-stop will be available”*  
(PRA Business Plan, 9 April 2018)

# Brexit – EU27 position

- Transitional Agreement – all good for financial services?
  - Transitional agreement still not a done deal – subject to Article 50 deal within next 12 months
  - ECB instructs financial institutions to prepare for “a no-deal scenario leading to a hard Brexit with no transition”
- Living with fragmentation post-Brexit
  - Andreas Dombret (Member Executive Board of Deutsche Bundesbank): “*with a view to the financial services sector, a far-reaching free trade agreement is rather unlikely given the UK's aspired exit from the single market and the customs union*”

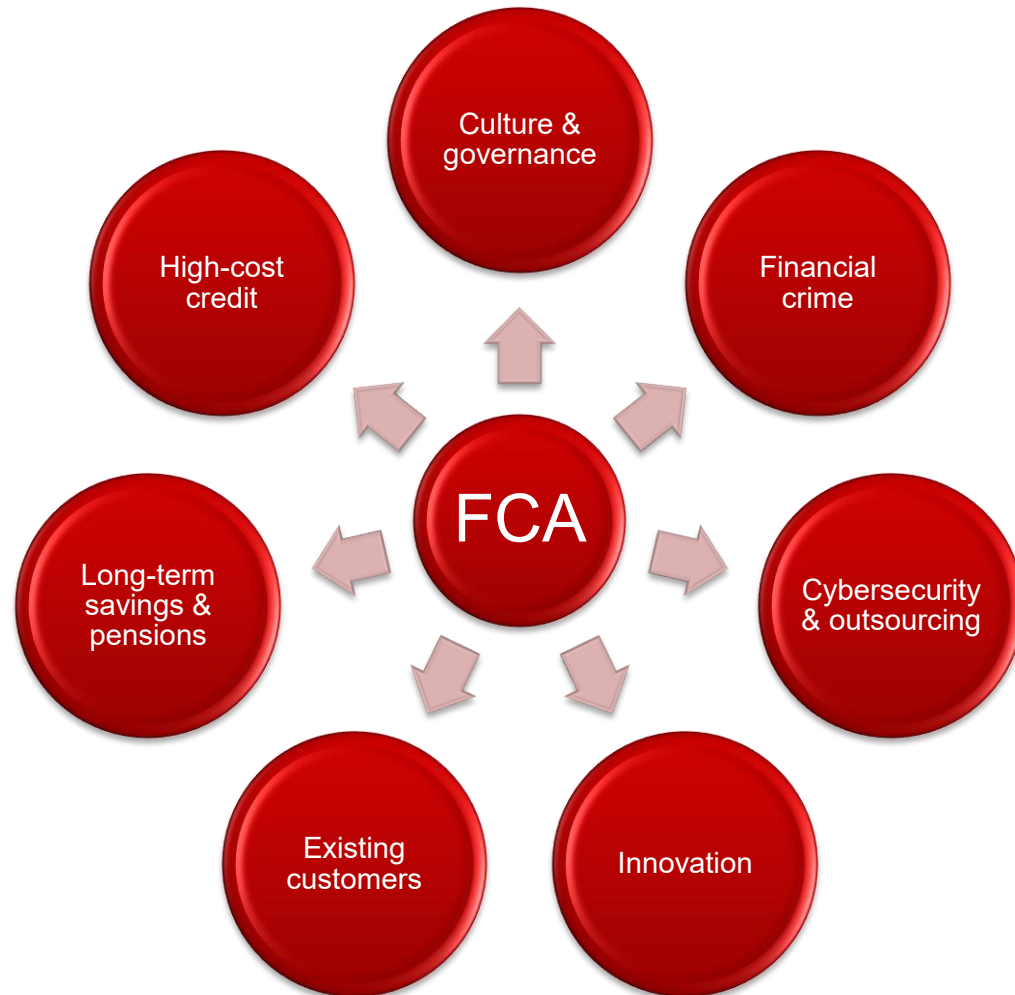
The background of the slide is a blue-tinted financial line chart. It features a grid of dashed lines and several jagged lines representing data trends. The lines are primarily blue and white, set against a dark blue background. The chart appears to be a candlestick or line chart, with the lines showing significant volatility. The overall aesthetic is professional and data-oriented.

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# FCA and PRA Business Plans

## Nicola Higgs

# Key areas of focus (non-Brexit)



# New FCA initiatives of note

Discussion Paper on introducing a duty of care

Discussion Paper outlining policy thinking on cryptocurrencies

“Approach to Market Integrity” document

Consultation on establishing a public register of certified persons

FCA to look at firms’ remuneration arrangements, particularly firms not subject to one of the Remuneration Codes

MiFID II focus points: research, best execution, PFOF, algorithmic trading

Monitoring compliance with the new IPO rules

Diagnostic work on money laundering risks in capital markets, and in the e-money sector

Research on the impact of passive investment

Strengthened supervisory work on operational resilience

Thematic and firm-specific work on outsourcing

Developing a payments sector strategy



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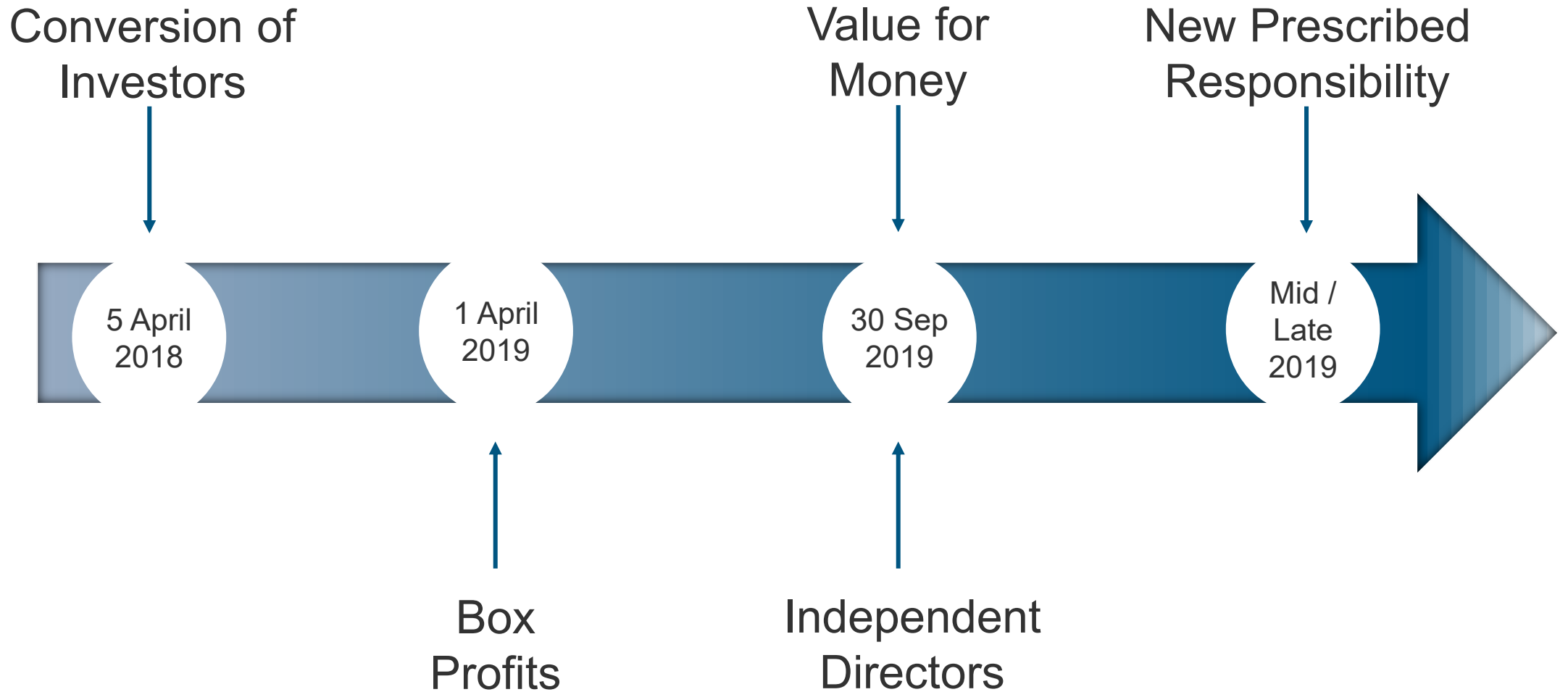
# FCA's Asset Management Market Study

## Nicola Higgs

# Background to the Market Study

- Published: 28 June 2017
  - FCA identified competition concerns: *“Our engagement process during the market study has indicated a possible lack of awareness of competition law in some areas of the sector, in particular as to how the law applies to commercial relationships and interactions with one another...”*
- Key findings:
  - Price competition is not working as effectively as it could be
  - Both actively managed and passively managed funds do not outperform their own benchmarks after fees
  - Concerns about how asset managers communicate their objectives and how useful these are for retail investors
  - Concerns in relation to the investment consulting market

# Final Rules (1)



# Final Rules (2)

- Conversion of investors (5 April 2018)
  - Subject to investors' best interests, managers can undertake mandatory conversion into cheaper but otherwise identical classes of the same fund without investor consent
  - Must be permitted by the prospectus
  - One-off notification obligation 60 days prior to mandatory conversion
- Box profits (1 April 2019)
  - Prohibition on retention of risk-free box profits
  - Instead pass for the benefit of investors
    - Guidance articulating what constitutes fair allocation regarding risk-free box profits
  - Disclose approach to box management in the prospectus

# Final Rules (3)

- Value for money (30 September 2019)
  - Asset managers are agents of investors and not simply product providers
  - Value for money tests to cover: fees and charges and quality of services
  - Assess value for money on an ongoing basis
  - Formally document results annually
- Independent directors (30 September 2019)
  - Minimum of 2 i-NEDs
  - Making up at least 25% of the total board membership
  - Applies regardless of the size of the manager
  - FCA considering introducing a higher threshold at a later stage

# Final Rules (4)

- Prescribed Responsibility (mid/late 2019)
  - New Prescribed Responsibility for fund managers: to ensure that a firm complies with its obligations on assessment of value; i-NEDs; and acting in the best interests of fund investors
  - Expectation this will sit with the Chair
  - In force in line with extended SMCR

# Ongoing consultation

- How fund objectives can be expressed more clearly and be more useful to investors
  - What is fund looking to achieve and how?
  - Constraints relating to the fund's portfolio construction
  - Non-financial objectives explained
  - FCA expectations for KIDs
- The use of benchmarks
  - Explain why benchmarks are used
  - Reference benchmarks consistently across fund documents
  - Ensuring that use of benchmarks as a constraint or as a target are explained
- Calculate performance fees net of other fees, in all cases
  - Note: MiFID II & PRIIPs presentation

A blue-toned background image featuring a financial line chart with multiple data series and a grid. The chart shows various peaks and troughs, typical of stock market data. The overall aesthetic is professional and data-oriented.

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# FCA's proposed new Financial Crime Systems and Controls guidance

Stuart Davis

# Objective of the guidance

- Proposal to add a **new Chapter 8** to Part 1 of the Financial Crime Guide, outlining the FCA's observations of good and bad practice regarding firms' systems and controls in relation to the requirement to detect, report, and counter the risk of insider dealing and market manipulation
- Amendments throughout the Guide to bring it up to date with recent regulatory developments and enforcement cases
- Comments are requested by 28 June 2018, and the FCA proposes that the new guidance will come into effect on **1 October 2018**
- Four key themes: governance, risk assessment, policies and procedures, and ongoing monitoring

# Governance

- **Senior management** must take responsibility for the firm's measures to counter insider dealing and market manipulation
- This means understanding the risks to which the firm is exposed (including understanding the legal definitions of insider dealing and market manipulation, and the ways in which the firm may be exposed), and establishing adequate policies and procedures
- Senior management should also manage the potential conflict of interest between **revenue generation** and **countering financial crime**

# Governance

<b>Examples of Good Practice</b>	<b>Examples of Poor Practice</b>
Senior management are able to recognise and articulate the warning signs that insider dealing and market manipulation are taking place	There is little evidence that possible insider dealing or market manipulation is taken seriously by senior management. Addressing these risks is seen as a legal or regulatory necessity rather than a matter of true concern for the business
Senior management regularly receive management information in relation to possible insider dealing or market manipulation	Senior management considers revenue above obligations to counter financial crime
The individual(s) responsible for overseeing the firm's monitoring for suspected insider dealing and market manipulation has regular interaction and shares relevant information with the MLRO	Senior management considers the firm's financial crime obligations are fulfilled solely by submitting a STOR and/or SAR
Senior management appropriately supports decisions proposed by Compliance	The Compliance function has limited independence and the first line can block concerns from being escalated

# Risk Assessment

- Firms must assess and regularly review the risk that they may be used to facilitate insider dealing or market manipulation taking into account a number of factors, including: **client type; products; instruments; and services offered/provided by the firm**
- Firms must take appropriate action to mitigate the risks identified, including:
  - Undertaking enhanced order and transaction monitoring on clients;
  - Setting client-specific pre-trade limits; and
  - Ultimately declining business or terminating client relationships if appropriate

# Risk Assessment

Examples of Good Practice	Examples of Poor Practice
Insider dealing and market manipulation risks are assessed across every asset class and client type the firm operates with	Risk assessments are generic, and not based upon the firm's own observations
There is evidence that the firm's risk assessment informs the design of its surveillance controls	An inappropriate risk classification system makes it almost impossible for a relationship to be considered 'high risk'
The firm's risk framework is regularly tested and reviewed	Risk assessments are inappropriately influenced by profitability of new or existing relationships
Where a firm identifies a risk that it may be used to facilitate insider dealing or market manipulation, it takes appropriate steps to mitigate that risk	The firm submits a significant number of SARs and STORs on a particular client, but continues to service that client without considering its obligation to counter the risk of financial crime
The firm considers where relationship managers might become too close to customers to take an objective view of risk. It manages that risk effectively	

# Policies and Procedures

- Policies and procedures should refer back to the firm's risk assessment, and need to focus on both **identifying attempted financial crime** and **mitigating future risks** relating to clients who have already been identified as having traded suspiciously
- Front office staff need to be made aware of the policies and procedures, and must be clear that they should **refuse to execute a trade when there is a clear risk of financial crime**
- Policies and procedures need to be **communicated** and **embedded** throughout the firm
- **Personal account dealing policies** need to ensure that conflicts of interest that might result in employees not escalating suspicious activity are avoided (e.g. mirror trades)

# Policies and Procedures

Examples of Good Practice	Examples of Poor Practice
The firm has clear and unambiguous expectations for its employees and anyone acting on its behalf, such as introducing brokers	The firm's policies and procedures aren't updated for legal or regulatory changes
Employees in dealing roles understand and are able to identify potentially illegal conduct, and their trading is regularly monitored by Compliance	Policies and procedures are generic and don't consider the specific processes or risks of the firm
The policies and procedures make adequate reference to the firm's risk assessment	Policies and procedures cover only post-trade identification and reporting of suspicious activity and are silent on countering financial crime
Policies and procedures make sure that the risk of financial crime is considered throughout the lifecycle of a security transaction, including before the order has been executed	The firm sets apparently robust procedures for assessing and mitigating identified financial crime risk, but sets thresholds for engaging these measures which mean that they are almost impossible to trigger
The firm takes swift, robust action for breaches of its policies and procedures	The firm doesn't have policies detailing the circumstances when a prospective or existing client would be rejected or have their relationship with the firm terminated
The firm has policies detailing when a prospective or existing client would be rejected or the relationship terminated	The firm doesn't have appropriate policies or procedures in place regarding personal account dealing, so that staff are able to deal in a manner which creates conflict in escalating suspected market abuse

# Ongoing Monitoring

- Firms must regularly consider whether their clients may be engaging in insider dealing or market manipulation, and consider the appropriate response when risks become apparent
- This includes **identifying patterns of behaviour** as well as **individual incidents**
- Emphasis on firms doing more than just reporting the suspicious activity — they need to consider what other measures they should take, such as undertaking enhanced monitoring of the client or ultimately considering the suitability of retaining the relationship
  - See **Julia Hoggett** speech November 2017
- Firms also need to consider how this monitoring interacts with the client on-boarding process and the firm's anti-money laundering framework

# Ongoing Monitoring

<b>Examples of Good Practice</b>	<b>Examples of Poor Practice</b>
The firm's monitoring seeks to identify trends in clients' behaviour, in addition to one off events	Firm believes that its obligations cease when it reports the suspicious transactions and orders
The firm undertakes enhanced monitoring of clients it has determined are high risk	Suspicious transactions and orders are identified but not investigated further
The firm conducts regular, targeted monitoring of voice and electronic communications	Suspicious transactions and orders are identified but not investigated further
Front office employees escalate suspicious activity promptly to Compliance	Monitoring identifies individual suspicious events but does not attempt to identify patterns of suspicious behaviour by the same client or a group of clients, using, for example, historical assessments of potentially suspicious activity or STORs submitted
The firm conducts regular monitoring of its staff trading activity, including proprietary and personal account dealing	The firm does not use information obtained via monitoring and subsequent investigation to consider the suitability of retaining a client relationship



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FCA's discussion paper on  
transforming culture  
Rob Moulton

# Transforming Culture in Financial Services – FCA DP18/2

- Unusual approach from FCA
  - 28 essays over 85 pages to provoke debate
  - Jonathan Davidson (Director of Supervision) brings out key themes in an Overview
- FCA's historical approach
  - Culture is the way things get done in an organisation
  - The tone from the top is very important
  - Culture can be measured
  - Individual accountability is an important aspect

# FCA's outlook

*“The financial services industry, in particular, has demonstrated instances of rate-rigging, rogue trading and mis-selling in the last ten years since the global financial crisis. Despite record fines, increasing investigations, and an expanding compliance industry, misconduct remains. Why? What have we not learned?”*

# Modifying FCA's traditional approach

- You cannot really measure culture (at least, not fully or very well)
  - “Leaders can manage culture even if they can’t measure it very well”
  - Data may give false levels of confidence
- Prioritise role of middle management

# Middle management example

- Organisation sets unrealistic targets from the top
- Customer-facing employees give up and ignore them
- Middle management incentivised by targets
  - “Creatively search for what we call structural vulnerabilities [to] conceal fake performance”
  - Definition of “sales call” expanded to include emails
  - Quid pro quo arrangements with colleagues
  - Sales data entry delayed to avoid detection as fake

# Quiz Question - can you identify this recent “culture” disciplinary case?

- Minor infractions / attitude had been questioned
- Middle manager instructed junior to engage in prohibited conduct – they agreed
- Boss of middle manager aware but did not act to stop it
- Caught out by monitoring (by expert poacher turned game keeper)
- Gain would have been minor, ultimate costs (fines / loss of income / bans) many times in excess of potential gain
- Ultimate Head of Organisation said they did not know, but resigned



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Questions?