

A blue-toned background image 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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3 October 2018

Financial Regulation Monthly Breakfast Seminar

Overview

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- Whistleblowing – an update
 - PRIPs Regulation – a focus on key market developments ahead of the planned Commission review
 - LIBOR transition and the recent Dear CEO letter
 - The Treasury Committee’s report advocating the regulation of crypto assets
 - Market Watch 56 and its observations on market abuse monitoring and Payment For Order Flow



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Whistleblowing – an update

David Berman

Context

- Key legal / regulatory obligations
 - Contravention could jeopardise firm's continuing satisfaction of Threshold Conditions (suitability), or an individual's on-going fitness and propriety, or could amount to a breach of the Employment Rights Act 1996
- Inextricable link to culture
- Several recent high-profile cases
- Some instructive recent 'war stories'

Legal / regulatory framework

- SYSC 18
- MiFID
- Employment Rights Act 1996 (“qualifying disclosures”)

Specific regulatory requirements (1)

Overarching Obligation

- A firm must establish, implement and maintain appropriate and effective arrangements for the disclosure of 'reportable concerns' by whistleblowers

Specific regulatory requirements (2)

- ‘Reportable concerns’
 - Very wide-ranging
 - Covers:
 - Anything that would be the subject of a protected/qualifying disclosure **including** breaches of FCA rules, principles or evidential provisions;
 - A breach of the firm’s policies and procedures; and
 - Behaviour that harms or is likely to harm the **reputation** or financial well-being of the firm
- ‘Whistleblower’: any person that has disclosed or intends to disclose a reportable concern to a firm, or the FCA / PRA, or in accordance with the protected disclosure provisions of the Employment Rights Act 1996 (“**ERA 1996**”)

Specific regulatory requirements (3)

- Firm's internal **arrangements** must at least:
 - Be able to **effectively handle** disclosures of reportable concerns, including: (i) where the whistleblower has requested confidentiality or has chosen to remain anonymous; and (ii) allowing for disclosure through a range of communication methods
 - Ensure **effective assessment and escalation** of reportable concerns
 - Include **reasonable measures** to prevent victimisation of the whistleblower
 - Provide **feedback** to a whistleblower, where feasible and appropriate
 - Include the **preparation and maintenance** of: (i) appropriate records of reportable concerns and the firm's treatment of these reports, including the outcome; and (ii) up to date written procedures that are readily available to the firm's UK-based employees, outlining the firm's processes for compliance

Specific regulatory requirements (3) (cont.)

- Firm's internal **arrangements** must at least:
 - Include the preparation of: (i) an annual **report** to the firm's governing body on the operation and effectiveness of its whistleblowing systems and controls; and (ii) prompt report to the FCA about each case lost by the firm before an employment tribunal (relating to protected disclosure or unfair dismissal)
 - Include **appropriate training** for UK-based employees, managers of UK-based employees (wherever the manager is based) and employees responsible for operating the firm's internal arrangements (see SYSC 18.3.4G)

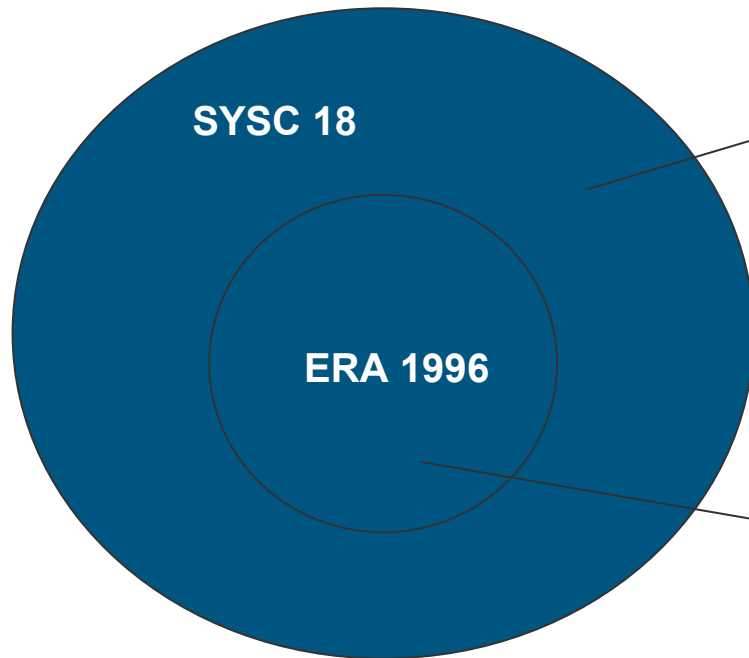
Specific regulatory requirements (4)

- Whistleblowers' Champion
 - Responsible for ensuring and overseeing the **integrity, independence** and **effectiveness** of the firm's policies and procedures on whistleblowing, including those policies and procedures intended to protect whistleblowers from victimisation
 - Should have sufficient level of authority and independence within the firm and access to adequate resources
- Reporting by employees to regulators
 - Firms must communicate to their UK-based employees that they may disclose reportable concerns to the FCA / PRA and the methods for doing so
 - Firms must make clear that:
 - Reporting to the FCA / PRA is not conditional on a report first being made using the firm's internal arrangements;
 - It is possible to report using the firm's internal arrangements and also to the FCA / PRA simultaneously or consecutively; and
 - It is not necessary for a disclosure to be made to the firm in the first instance

Specific regulatory requirements (5)

- Employment Rights Act 1996
 - Qualifying disclosure/protected disclosure
 - Protected from detriment (s.47B)
 - Enhanced unfair dismissal protection (s.103A) – usual cap of lesser of circa £95k and annual salary disappplied
- Settlement Agreements
 - Workers must **not** be fettered / restricted from making a protected disclosure and this must be expressly stated in any settlement agreement
 - Firms must **not** request that workers enter into warranties which require them to disclose to the firm that: (i) they have made a protected disclosure; or (ii) they know of no information which could form the basis of a protected disclosure
 - Firms must **not** use measures intended to prevent workers from making protected disclosures

Scope of regulatory obligations



- Breaches of FCA Rules, principles, evidential provisions
- Breaches of firm's policies and procedures
- Breaches likely to harm the firm's reputation/financial well-being
- Qualifying/protected disclosure

Some questions

- How (and how effectively) does the firm monitor the **appropriateness and effectiveness** of its arrangements?
- Where are internal awareness levels?
- What do / might whistleblowing statistics tell us?
- Is training effective / appropriate?
- How detailed and thorough is our policy?

Practicalities

- Reviewing whistleblowing handling / escalation procedures
- Consider **testing** awareness periodically
- Assurance role for Internal Audit?
- Assuring confidentiality / anonymity
 - Potential minefield: tread very carefully!
- Is training mandatory?
 - Is this monitored / enforced?
- Beware: the perils of pre-judging (however bizarre the allegations)
- Inter-connectivity with complaints / grievance procedures
- Use of external counsel
 - Privilege considerations

War stories

- ‘Innocent’ motivations
- Individual (personal) versus firm considerations
 - Can be very tricky to identify / manage in reality
- Likely **perception** of a situation often ignored / overlooked
 - Paper trail can look awful
- Importance of learning from mistakes
- Intricacies / delicacies of bringing someone into the ‘circle of knowledge’
- Technical ‘whistleblow’ or not – splitting hairs?
- Responding vs being seen to respond

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

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PRIIPs Regulation – a focus on key market developments ahead of the planned Commission review

Nicola Higgs

PRIIPs Regulation – Current issues and status

- Article 33 PRIIPs Regulation:
 - “By **31 December 2018**, the Commission shall review this Regulation. The review shall include, on the basis of the information received by the ESAs, a general survey of the **operation of the comprehension alert**, taking into account any guidance developed by competent authorities in this respect. It shall also include a survey of the **practical application of the rules** laid down in this Regulation, taking due account of developments in the market for retail investment products and the feasibility, costs and possible benefits of introducing a label for social and environmental investments. As part of its review, the Commission shall undertake **consumer testing** and an **examination of non-legislative options** as well as the outcomes of the review of Regulation (EU) No 346/2013 regarding points (c), (e) and (g) of Article 27(1) thereof”

PRIIPs Regulation – Current issues and status

FCA Call for Input (closed 28 September):

- Scope of PRIIPs Regulation
 - *“Reports from market participants suggest it may not always be clear whether certain investment products are PRIIPs – in particular, whether certain corporate bonds (such as corporate bonds with ‘make-whole’ clauses or callable bonds) are in or out of scope”*
- Content of the KID
 - Transaction costs
 - Risk disclosures
 - Performance scenarios

PRIPs Regulation – Current issues and status

ESAs letter: Scope for corporate bonds (19 July 2018)

Type of feature	Considerations	ESA's conclusion
Perpetual	There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is perpetual	Out of scope
Subordinated	There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is subordinated.	Out of scope
Fixed rate	<p>There are not considered to be any fluctuations in the amount repayable. This would include:</p> <ul style="list-style-type: none"> - bonds with coupon payments fixed at a defined interest rate until maturity, including at zero; - bonds with pre-defined changes in the coupon rate at fixed times prior to maturity. 	Out of scope
Variable rate	<p>The amount repayable is considered to be subject to fluctuations based on changes in the coupon rate. It is relevant to consider the basis for those fluctuations and whether there is any structuring.</p> <p>Pre-defined increases in the coupon rate (i.e. coupon step-ups) which are not linked to a reference value or to the performance of one or more assets which are not directly purchased are not considered to result in a bond being a PRIIP. This is considered to include changes due to a ratings downgrade of the issuer, change of control event, or tax or regulatory event.</p> <p>Where there is a direct link (with or without a spread that reflects the credit risk of the issuer) to an interest rate index, it is still considered to be an asset that is directly held unless there is additional structuring, such as a cap or floor (other than at zero); c.f. definition of a structured deposit.</p>	Not all variable rate bonds are considered to be in scope, but it is dependent on the specific feature.

PRIIPs Regulation – Current issues and status (cont.)

ESAs letter: Scope for corporate bonds (19 July 2018)

Type of feature	Considerations	ESA's conclusion
Puttable	Provisions that allow the investor to sell the bond back to the issuer are considered to be a contractual right to exit the investment and not to result in a bond being a PRIIP.	Out of scope
Callable	<p>It is considered that provisions that allow the issuer of the bond to redeem the bond before maturity constitute a contractual termination of the investment and therefore do not inherently result in a fluctuation based on an exposure to a reference value.</p> <p>However, such features may result in that bond being a PRIIP, where the amount repayable at redemption is not fixed and fluctuation is caused by exposure to a reference value.</p> <p>The inclusion of a clause that allows the issuer to pay off the remaining debt early using a reference rate to determine the net present value of future coupon payments that will not be paid (i.e. make whole) is expected to mean that the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values. However, where the mechanism to calculate the discount rate is known in advance to the retail investor, this could be considered as a separate case, which does not satisfy the criteria in Article 4(1).</p>	Not all callable bonds are considered to be in scope, but some are expected to be on the basis of the specific feature.
Convertible	Where the investor or issuer may convert the bond into shares of the bond issuer (or shares of another company) the amount repayable is considered to fluctuate based on the performance of an asset that is not directly purchased.	In scope

PRIIPs Regulation – Current issues and status

EUSIPA / UKSPA: Issues for structured products

- Performance scenarios and costs – annualised figures and recommended holding periods
- Return adjustment
- Risk based discounting
- The publication of KIDs on a public section of a PRIIP manufacturer's website

The background of the slide is a blue-toned financial line chart. It features a grid of dashed lines and a prominent, thick blue line that fluctuates across the chart, representing market data. The overall aesthetic is professional and data-oriented.

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LIBOR transition and the recent
Dear CEO letter
Carl Fernandes

The context

Background

- 2017: regulators push for market-led transition away from LIBOR by end of 2021
- Various concerns about future of LIBOR – decreasing number of transactions; submitters wanting to withdraw; querying whether it is the appropriate risk price for all transactions to which it is applied
- Current submitting banks voluntarily agreed to submit to end of 2021
- Against backdrop of international efforts to identify more robust interest rate benchmarks
- 2018: some concern about progress

The context (cont.)

Regulatory basis for action

- Broader concerns are financial stability and market integrity
- Users need to have robust fallback plans under EBR; Administrators under EBR to make sure that benchmarks are sufficiently representative of the economic reality they intend to measure

What is notable about the letter?

- Use of “Dear CEO” indicates a raised temperature and confirms concern that not enough has been done to date
- Expectation to undertake a “comprehensive risk assessment of the prudential and conduct impacts associated with transition in a range of different scenarios”
- Request to deliver by 14 December a “board-approved summary of your firm’s assessment . . .and details of actions you plan to take to mitigate those risks”

Suggestions for firms

- Get cracking if you haven't already!
- Assemble a cross discipline project team
- Compile an inventory of touch points/exposures – identifying where you are “using”; calibrate the scale of the task
- Formulate a plan for transition, identifying risks, distinguishing legacy and new positions
- Identify where the current plan is to rely on industry initiatives, and what your contingency plan is
- Formulate a strategy for communicating with clients and other stakeholders
- Regularly track progress and update the risk committee/board



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The Treasury Committee's report
advocating the regulation of crypto assets
Stuart Davis

The Treasury Committee's report advocating the regulation of crypto assets

- House of Commons Treasury Committee proposes that the UK government should urgently regulate crypto assets likening the UK crypto market to the “Wild West”
- Also suggests that regulation could help the UK become a global hub for digital assets
- Suggestion is to amend the FSMA (Regulated Activities) Order to include crypto assets, focusing in particular on crypto exchanges and ICO issuers

The Treasury Committee's report advocating the regulation of crypto assets (cont.)

- A number of interpretative issues with that approach:
 - Scope and consistency with existing regulation that applies to crypto assets
 - Generic or bespoke regime?
 - Application of existing regulatory rules
 - Licensing (c.f. issuers of debt and equity)
 - Conduct rules (e.g. best execution)
 - Product governance
 - Prospectus requirements
 - Interplay with MLD5
- FCA consultation paper due to be published Q4 2018



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Market Watch 56 and its observations on
market abuse monitoring and Payment For
Order Flow
Anne Mainwaring

Market abuse surveillance

- FCA raises concerns in relation to the calibration of firms' surveillance systems
 - Vendor supplied systems using 'out of the box' and 'industry standard' settings to calibrate alert parameters
 - Use of average peer alert volumes as a benchmark for calibration
- To satisfy the MAR requirements each firm's surveillance arrangements, systems and procedures must be appropriate and proportionate to the scale, size and nature of their business activity
 - Evidencing the basis of alert calibration

Market abuse surveillance (cont.)

- Linear Investments Limited – fine of £409,300
 - Failed to appropriately calibrate and test its automated post-trade surveillance system so that it was operating effectively relative to the nature of its business
 - Refers to four previous issues of Market Watch
 - Also taken into account in relation to the seriousness of the breach

Payment For Order Flow (PFOF)

- Market intelligence pre-MiFID II suggested some firms were still charging PFOF for ECP business
- Accordingly this is where the FCA is focusing its supervisory work
- Firms should, for a given transaction, analyse the capacity in which they and the different counterparties involved act, rather than look to counterparties' general business models
- “We will take action against firms who characterise their relationship with liquidity providers in a way that does not reflect economic reality and which are PFOF arrangements”



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Questions?