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BULLETIN | FINANCIAL SERVICES AND REGULATION

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Welcome to another edition of our United Kingdom Financial Services and Regulation Bulletin. This month has seen the Financial Conduct Authority ("FCA") bare its teeth as the new Consumer Credit regulator over unfair and misleading debt collecting practices carried on by the payday lender Wonga. It has also heavily fined Credit Suisse and Yorkshire Building Society for producing misleading financial promotions. Meanwhile, Martin Wheatley has delivered a speech which outlines the increasing role technology is playing in the financial services sector, and how the FCA intends to harness it. In addition, the FCA has also published the Policy Statement on its controversial overhaul of the CASS rulebook, which proposes sweeping changes to the current rules.

For an update on developments in the European Union, please see this month's bulletin here.

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SPEECHES

1. MARTIN WHEATLEY SETS OUT THE TECHNOLOGICAL CHALLENGES FACING THE INDUSTRY

On 10 June 2014, the FCA published a speech delivered by Martin Wheatley, its CEO, at Lansons in London. In the speech, Mr Wheatley set out the challenges and opportunities presented to firms in the financial services sector by technology. He stated that the pace, volume and origin of change in technology, both transformational and global is unprecedented, but, far from being daunted by this, firms must embrace it. However, he cautioned that there was a regulatory responsibility on the shoulders of the FCA to ensure that this change is handled in the best possible way so that it benefits consumers and does not compromise the markets.

He maintained that the innovation in technology had opened up a new wave of possibilities in the financial services sector, but that in turn, technology had become a much more serious risk for firms. He explained that the challenge was to ensure that innovation was welcomed, whilst the risks were reduced as much as possible. Therefore, in response to this, the FCA has launched "Project Innovate" to ensure that positive developments in technology which are designed to improve the lives of consumers or clients are supported by the regulatory environment. He stressed that the most pressing priority was to ensure that tech-led improvements, such as mobile banking, P2P and next gen data processing, can be safely fast tracked into the UK. The FCA is working closer than ever before with financial services firms and particularly where such firms are developing innovative approaches to services that are not explicitly covered by regulatory rules or where the FCA's guidance is ambivalent.

As part of the FCA's initiative, it will be opening up a hub to provide more bespoke support to innovators by offering compliance expertise to firms developing new models or products; launching an incubator to support innovative, small financial businesses to get ready for authorisation; and by looking for areas where the system itself needs to adapt to new technology or change. Mr Wheatley also mentioned that the FCA would be publishing a consultation paper focusing on technology in July.

The speech touched on high frequency trading ("HFT") and what Mr Wheatley called its "undoubted benefits", such as the link between competition and market efficiency, liquidity and reduced transaction costs. However, he highlighted the fact that there were definite risks connected to HFT, including those attached to market fairness, cleanliness and resilience. He stated that it was, therefore, crucial the FCA was able to meet this challenge and offer the necessary protections to service users in the market place. He stated that the FCA and PRA would also be working to improve and test resilience to cyber-attacks in the financial services sector.

UK PUBLICATIONS

1. FCA PUBLISHES LONG AWAITED FINAL RULES ON CASS

The FCA published a Policy Statement containing its keenly anticipated new rules on the protection of client assets and money for investment firms (PS14/9). The new rules, which were published on 10 June, are a significant change to the previous client money and assets regime set out in the Client Money and Assets Sourcebook of the FCA Handbook ("CASS"). The overhaul, which was carried out to address the lessons learnt following the failure of Lehman Brothers, began in July last year with the publication of Consultation Paper 13/5. However, it also comments on Consultation Paper 12/22, published in September 2012, which proposed new rules to deal with multiple pools and the European Markets Infrastructure Regulation ("EMIR").

David Lawton, Director of Markets at the FCA said that the "changes will improve the protection offered to client assets and should speed up the recovery of client assets on the failure of a

firm". He also stated that the changes would go a long way to ensuring that confidence in UK markets is maintained and consumers are protected.

The final rules provide a complete re-write of the client money rules in CASS 7 and substantial changes to the custody rules in CASS 6. Amongst these key changes are new requirements relating to the banking exemption, the Delivery versus Payment Window and requirements in relation to title transfer collateral arrangements ("TTCAs"). There are also new provisions allowing clearing member firms which operate net margined omnibus client accounts at EMIR-authorised recognised central counterparties to offer multiple client money pools to their clients.

The FCA has decided not to proceed with the majority of proposals it consulted on surrounding the client money distribution rules. It has said it will conduct a further review of these rules in line with the HM Treasury's implementation of the Special Administration Regime review.

The FCA is introducing the new CASS rules in three stages:

- on 1 July 2014 measures which clarify existing rules and guidance, or impose minimal regulatory burden and introduce optional arrangements for firms come into force
- on 1 December 2014 rules relating to the provision of information to, or obtaining the agreement of, new clients will come into force; and
- on 1 June 2015 the remaining rules and guidance will come into force.

The requirements which come in from 1 December 2014 will only apply to new arrangements made with new clients and arrangements with existing clients which have been materially changed.

2. FCA UNVEILS ENHANCED SUPERVISION IN STATEMENT OF POLICY

On 19 June 2014, the FCA issued a Statement of Policy which responds to the Parliamentary Commission on Banking Standards' ("PCBS") proposal for the regulators to receive additional supervisory powers. Amongst other matters, the statement sets out a new approach, known as "Enhanced Supervision", to be used when the FCA identifies fundamental failings of standards, governance and culture in firms. Enhanced Supervision draws on powers already available to the FCA.

The FCA provides a number of potential indicators for failings which could lead to Enhanced Supervision, such as evidence of control areas such as Risk, Compliance and Internal Audit being poorly managed, under-resourced, or unable to make their voices heard at board level; a poorly functioning board; numerous or especially significant conduct failings; and evidence of weak risk management. Once a firm is put in Enhanced Supervision, its FCA supervisors will review matters to ensure there is a plan in place to return the firm to normal supervision within a specified period. The FCA will consider which tools and powers are most suitable to address any failings and progress against the plan will be monitored regularly.

The document also sets out how the FCA will use its current supervisory powers in general to address serious failings within firms. The PCBS recommended in its report "Changing Banking for Good", published last year, that the UK regulators be given further powers to deal with failings in the higher echelons of banks. In the statement, the FCA has made it clear that it, together with the Prudential Regulation Authority ("PRA"), is already able to address any failings by applying existing powers appropriately.

As well as devising the new "Enhanced Supervision" approach, the Statement of Policy sets out how the FCA will address standards, governance and culture as part of regular supervision, and explains how the FCA and PRA will work together to ensure that systemic weaknesses within firms are identified and addressed effectively and efficiently. The PRA also published updated versions of its own statements of policy in this area.

3. FCA DISCUSSES COSTS OF ADMINISTERING "REGULATORY GATEWAY"

On 23 June 2014, the FCA published a Discussion Paper (DP14/1) inviting views on how it should recover costs from firms incurred in administering the authorisation process or "regulatory gateway". It discusses the FCA's role as the regulatory "gatekeeper", which is to ensure that any applicants and individuals wishing to enter the financial services industry meet the FCA and PRA standards and are equipped to operate correctly in the market. However, the Paper also discusses how best to distribute the recovery of authorisation costs between different fee-payers and suggestions for revising the level of application fees. The FCA states that the original policy and application fee structure has not changed since 2000, when the Financial Services Authority, the FCA's predecessor regulator, was set up and has not been reviewed since 2006/2007. In particular, the rates have not changed since 2001, apart from a reduction in 2004 to the "straightforward" fees (from £2,000 to £1,500) paid by the smallest firms. Therefore, fees have actually gone down in real terms and the FCA believes that now is the right time to review the policies.

With regard to the distribution of the recovery of authorisation costs, the FCA is inviting stakeholders' views on proposals to share the costs of applications between applicants and existing fee-payers more equally. For example, it believes that were it to charge no application fees at all, periodic fees paid by firms would rise above minimum fee thresholds by only 0.4%. Equally, if it were to recover all processing costs from applicants, periodic fees would be reduced by just 0.8%. The FCA also proposes the possibility of sharing costs between more and less complex applications more effectively.

The FCA also proposes to revise application fees by introducing a new fees category for very straightforward applications, thereby weighting fees towards more complex applications. It also proposes to introduce charges for changes in control.

The FCA wishes to receive responses from stakeholders by 22 August 2014, so that it may take into account all responses when preparing proposals for consultation in this area in October 2014. The PRA also intends to publish a consultation paper on application fees at the same time. The FCA wishes to implement any new proposals from 1 April 2015 onwards.

4. PRA PUBLISHES ANNUAL REPORT FOR 2014/15

The PRA published its Annual Report for 2014 on 17 June. It contains the PRA's Business Plan for 2014/15 which provides the timings for publication of consultations and anticipated completion dates for "key deliverables". The Business Plan is based on aims which were set out in the PRA statement of strategy for 2014/15, published in March 2014.

The PRA states that between June and August this year it intends to consult on, amongst other issues: the transposition of Solvency II; the liquidity coverage requirement; remuneration; and the senior manager regime for banks, building societies and insurers. It also wishes to obtain views on: the structural reform of banks; the PRA Rulebook; and insurance policyholder protection between September 2014 and November 2014. By February 2015, it intends to have published consultations on Pillar II Capital for Banks and the extent of contributions by external auditors to prudential supervision.

With regard to its "key deliverables", the PRA stated that it will:

- complete the transition of the largest firms to the periodic summary meeting supervisory cycle between June 2014 and August 2014;
- issue a Policy Statement on the PRA's approach to supervision of overseas entities between September and November 2014;

- implement the stress testing initiative for the largest eight UK banking groups between September and November 2014; and
- provide feedback and final rules on the transposition of Solvency II between December 2014 and February 2015.

The PRA has also requested responses in relation to the Annual Report itself and the way in which the PRA has discharged its functions during the period of the Report. It also requests feedback on the extent to which it has advanced its statutory objectives and considered its regulatory principles. The consultation will close to responses on 17 September 2014.

5. FCA CONSULTS ON IMPLICATIONS FOR CASS AFTER ISA RULE CHANGES

On 11 June 2014, the FCA published a Consultation Paper (CP14/9) on the implications for the client money and assets rules of the changes to the requirements for Individual Savings Accounts ("ISAs"). The Government proposed in the 2014 Budget to allow cash savings to be held in stocks and shares ISAs, which would give individuals the opportunity to use stocks and shares ISAs for deposit and investment purposes at the same time. The new rules on ISAs will come into force on 1 July 2014, so the FCA requested that all responses to its consultation were received by 25 June 2014. The consultation has now closed.

The FCA states that the changes, set out in the 2014 Budget, are likely to cause ambiguity to the status of the money investment firms managing stocks and shares ISAs hold within the ISA tax wrapper. The client money and assets rules set out in the FCA's Client Assets Sourcebook ("CASS") require firms to hold client money under a statutory trust separately from money which is not considered client money. The FCA believes that it may now not be clear whether money held within a stocks and shares ISA is either deposit money or held for the purpose of investment. Money which is held for the purposes of investment would be client money under the CASS rules, but money held for non-investment purposes would not be subject to the CASS rules.

Under the Consultation Paper, the FCA proposes that:

- all investment managers who hold money within stocks and shares in ISAs will be required to hold these sums as client money;
- investment firms who manage cash ISAs should be allowed to opt-into the CASS rules and elect to hold money in cash ISAs as client money; and
- the money held as client money by ISA managers should be excluded from rules preventing firms from holding client money as unbreakable term deposits with terms of longer than 30 days.

The FCA believes that these proposed changes will secure an appropriate degree of protection for consumers and will promote effective competition. The Paper also makes it clear that the rule changes to the client money regime set out in its recent Policy Statement (PS14/9) should not affect the proposed changes in this consultation.

6. HM TREASURY ANNOUNCES OPERATIONAL REVIEW OF WHOLESALE FINANCIAL MARKETS

On 12 June 2014, the UK Government announced that HM Treasury, the Bank of England ("BoE") and the FCA would be conducting a joint review into the way wholesale financial markets operate. It will be known as the "Fair and Effective Markets Review" and will be led by BoE Deputy Governor for Markets and Banking, Minouche Shafik, and supported by Martin Wheatley, Chief CEO of the FCA, and Charles Roxburgh, Director General, Financial Services, HM Treasury as co-chairs.

The press release explains that the review is intended to build upon the actions the UK has taken to right the wrongs identified within the financial system, including the LIBOR reforms and the Parliamentary Commission on Banking Standards' ("PCBS") report, published last autumn, which proposed the new regime for senior managers within banks. The review will run for 12 months and by June 2015 is expected to make recommendations on:

- principles to govern the operation of fair and effective financial markets;
- reforms to ensure the standards of behavior are in accordance with those principles;
- tools to strengthen the oversight of market conduct;
- whether the regulatory perimeter for the wholesale financial markets should be extended, and to what extent international action is required; and
- additional reforms in relation to benchmarks in order to strengthen market infrastructure.

The press release also states that the Government will act to:

- extend the new legislation to regulate LIBOR to cover further benchmarks in the foreign exchange, fixed income and commodity markets, based on an early recommendation of the wholesale market review. The legislation is also to include new criminal sanctions;
- extend the Senior Managers and Certification Regime to cover all banks that have a presence in the UK, by bringing in foreign banks that have branches here. This is the regime proposed by the PCBS report in order to strengthen governance, culture and senior management responsibility in banks; and
- expand the tough UK criminal regime for market abuse, which includes not opting into the EU rules at this stage. The proposed UK rules will be as strong as or stronger than those of the EU, but will preserve flexibility to reflect specific circumstances in the UK's globally important financial sector.

The Government proposes to consult on these steps in the Autumn.

7. FCA DIRECTS FSMA RECOGNISED FUND OPERATORS TO SUBMIT ANNUAL COMPLIANCE CERTIFICATE

The FCA has directed operators of funds recognised under Section 272 of the Financial Services and Markets Act 2000 ("FSMA") to complete and return an annual compliance certificate relating to the recognised funds under their management. This direction was published on 25 June 2014. In accordance with the certificate, each operator must certify that during the most recent financial year:

- it has taken reasonable steps to inform itself of any changes to the regulatory requirements for the relevant type of comparable authorised scheme (as defined within FSMA) taking effect during this period; and
- it has considered such changes together with any changes to the scheme that have occurred during this period and it considers that such changes do not adversely affect the scheme's ability to satisfy the requirements referred to in Section 272 of FSMA.

This requirement is set out under Section 277A of FSMA. The FCA explains that a single certificate may apply to multiple sub-funds in an umbrella scheme, so long as the names of each relevant sub-fund and the umbrella scheme are clearly identified. The certificate must also be signed by an authorised signatory of the operator, and the operator must seek out appropriate advice from professionals before signing. Recognised schemes under Section 272 FSMA include those recognised by Section 270 of FSMA before 22 July 2013.

The certificate should be provided no later than one month following the publication of the annual report and accounts for the scheme. Should this publication be delayed for any reason, the certificate must be provided no later than one month after the last day on which the publication was due. Operators will be expected to comply with this direction in the case of each financial year following 31 August 2014. The FCA explains that there are a number of circumstances in which a certificate will not be required where the operator has already submitted specific information to the FCA within the last 12 months.

CONSUMER CREDIT

1. FCA OFFERS GUIDANCE FOR THOSE TAKING ON CLIENTS FROM EXISTING DEBT MANAGEMENT FIRMS

The Consumer Credit Trade Association ("CCTA") published a memorandum and instructions issued to it by the FCA on 20 June 2014. The memorandum and instructions relate to the FCA's expectations of authorised consumer credit firms when taking on the customers of Debt and Claims Limited ("DCL") which has now exited the consumer credit sector. The FCA explained that the instructions within this document would apply to any authorised credit firm looking to take on customers from debt management firms looking to withdraw from the regulated sector.

The FCA explained that DCL voluntarily suspended its interim permission for consumer credit with immediate effect, so it would no longer be providing debt management services to new or existing clients. The sale of DCL's debt book to Angel Advance Limited was agreed on 20 June 2014. The FCA understands that since the transfer of clients will take time to complete, it encourages FCA-authorised firms to:

- Show due consideration towards DCL's clients and exercise forbearance and restraint during this period. This is consistent with the rules set out in the Consumer Credit Sourcebook ("CONC"); and
- Make the FCA aware of any non-FCA authorised firms which are not exercising similar forbearance towards DCL's clients. Where this is the case the FCA will take steps to intervene where appropriate, including passing on any information to any appropriate regulators (such as those in the utilities sector).

The FCA also states that it has contacted the Money Advice Service and a number of charitable bodies which provide free customer debt advice to make them aware of the current situation with regard to DCL. It believes that there will be other debt management firms which will exit the sector prior to it beginning its rigorous assessment of firms' wishes to obtain full FCA authorisation from 1 October 2014. The FCA expects any authorised firms to exercise similar restraint towards the clients of any other exiting firms.

2. WONGA SLAMMED FOR UNFAIR AND MISLEADING DEBT COLLECTION PRACTICES

On 25 June 2014, the FCA published the voluntary application for imposition of requirement which it has agreed with Wonga Group Limited, the UK's largest payday lender. Under this agreement, Wonga has been asked to pay compensation totaling over £2.6 million to around 45,000 customers for unfair and misleading debt collection practices.

The press release which accompanied the publication of the agreement states that Office of Fair Trading ("OFT"), the former consumer credit regulator, uncovered the fact that, between October 2008 and November 2010, Wonga and certain other group companies employed unfair debt collection practices in connection with their customers. In fact, Wonga sent communications to customers in arrears under the names of "Chainey, D'Amato and Shannon" and "Barker and Lowe Legal Recoveries" which led those customers to believe that their outstanding debt had been passed to a law firm, or other third party. The FCA stressed that these communications

threatened further legal action if the debt was not repaid and put customers under great pressure to make loan repayments that many would not be able to afford. The FCA took over the investigation on 1 April 2014 when responsibility for the regulation of consumer credit passed from the OFT to it.

The investigation found that both firms did not, in fact, exist and Wonga used these names in order to frighten its customers with a view to maximising collections. Under the agreement, the FCA provides that:

- Wonga must identify and pay redress to all affected customers. Some customers will receive cash, but others will have their outstanding balance reduced; and
- The FCA has appointed a skilled person to oversee the process and ensure that affected customers get what they are owed.

In addition, Wonga also reported to the FCA that it had discovered system errors, which were unintentional, relating to the calculation of customer balances where the inputs to these calculations (such as fees, balance adjustments or the timing used to calculate interest) were not consistently applied.

3. FCA PUBLISHES RESEARCH FINDINGS ON CONSUMER CREDIT SECTOR

On 5 June 2014, the FCA published a series of new websites which set out its findings from the research it commissioned ESRO to carry out on the Consumer Credit sector. It carried out in-depth assessments of particular areas of the consumer credit sector which the FCA considers to provide the highest potential risks to consumers. The areas covered were the credit card market, the debt management sector, log book loans and overdrafts.

In relation to credit cards, the FCA believes that the market may not be working well for certain groups of consumers and that many appear to have a limited understanding of how to manage spending on their cards in a sustainable way. It appreciates that there is a range of behavioural factors at play which may lead consumers not to choose or use cards in the best way for them. The FCA thinks that some consumers may be paying more than they realise or originally expected in relation to the interest on their balances, and it is concerned that these customers may also be subsidising users for whom card usage is free. The FCA has formed the view that there are underlying issues relating to business models and competition in the sector and it intends to launch a full market study later this year.

On debt management, the new FCA website states that it believes some firms are offering poor quality or incorrect advice, and that consumers have been receiving targeted advertising via the use of lead generators in the sales process. The FCA's research found that most consumers would approach debt management providers only when in urgent need of help and that most also had low financial capability. In its view many consumers have a very limited knowledge of the market and put a good deal of trust in debt management providers, rather than shopping around, and they like to rely on recommendations, adverts and basic internet searches. To this end, consumers may suffer detriment including poor value for money, being offered unsuitable solutions and providers not managing client money appropriately. The FCA also found that there was often a lack of clarity regarding the charges involved in a debt management plan. Therefore, it will assess the quality of advice provided by debt management services in an in-depth thematic review, and subject debt management providers to the full rigor of the FCA's supervision programme going forward. The FCA explains that it will take swift action where it identifies breaches and in concluding existing investigations initiated by the OFT.

The new webpage on log book loans states that, primarily, log book lenders must raise their standards. The FCA believes that there is clear evidence of poor behaviour by firms in connection with advertising, communication and interaction with customers. The FCA also believes that

there is little competitive pressure on firms to offer good a value log book loans, since there is weak competition in the sector and consumers do not understand the products well either. It is concerned that lenders may be able to use the threat of vehicle repossession to pressure consumers to make high and, potentially, unaffordable loan repayments. The FCA has made it clear that this is a priority area for it going forward.

With regard to overdrafts, the FCA's findings show that overdraft providers are able to earn revenue from the lack of understanding, confusion and limited attention of customers. It also believes that providers have historically had very high, complex and opaque charges for unauthorised overdrafts which still appears to be the case. Whilst the FCA considers that the voluntary measures agreed between the Government, the OFT and the industry have helped to reduce overdraft costs there are still a significant number of overdraft users who are potentially paying far too much for the service. The FCA is currently investigating how providers set and monitor overdraft limits, together with their governance arrangements and strategies for doing so.

INVESTIGATIONS AND ENFORCEMENT

1. FINANCIAL PROMOTIONS FAILURES LEAD TO FCA FINES FOR CREDIT SUISSE AND YORKSHIRE BUILDING SOCIETY

On 16 June 2014, the FCA published final notices issued to Credit Suisse International ("CSI") and Yorkshire Building Society ("YBS"). The final notices were issued in connection with financial promotions for a product manufactured by CSI, the Cliquet Product, which were deemed to fall foul of the requirement that they should be clear, fair and not misleading. CSI was fined £2,398,100 and YBS was given a £1,429,000 fine. Both fines were reduced by 30 per cent, as the parties agreed to settle with the FCA at an early stage of the investigation.

The FCA found that, during the period between 1 November 2009 and 17 June 2012, both CSI and YBS breached Principle 7 of the FCA's Principles for Businesses ("PRIN") set out in the FCA Handbook, since they had failed to pay due regard to the information needs of their clients and had not communicated with them in a way which was clear, fair and not misleading. In addition, the FCA found that both firms had breached certain corresponding rules set out in the Banking Conduct of Business Sourcebook in the FCA Handbook ("BCOBS").

The Cliquet Product was designed as a structured capital protection product to provide a guaranteed minimum return with the apparent potential for significantly more if the FTSE 100 performed consistently well. The potential for more was subject to a gap on the potential maximum return offered by the product. The FCA found that the probability of achieving only the minimum return was 40-50 per cent and the probability of achieving the maximum return was close to 0 per cent. The advertisements and materials issued by both CSI and YBS made the potential maximum return on the product a key promotional feature. However, given that both CSI and YBS knew that there was next to no likelihood of obtaining the maximum return, the FCA believed it inappropriate to emphasise the maximum return in the advertising. In addition, the FCA found that CSI did not review its long running promotions on a periodic basis. Had there been any such review, it is possible that the problems with the marketing material might have been identified earlier.

Between November 2009 and June 2012, a total of 83,777 customers invested £797,380,716 in the Cliquet Product. CSI did not actually sell the product directly, but used third party distributors such as YBS which itself was responsible for around 75 per cent of the total amount invested. Affected customers will be offered the opportunity to exit the product without penalty.

The FCA press release announcing the publication of the final notices explains that this is the first time that it has taken action against both the manufacturer of a product and its distributor at the

same time. Tracy McDermott, the FCA Director of Enforcement and Financial Crime said that "financial promotions are often the primary source of information for consumers and in this case CSI and YBS let their customers down badly".

2. FCA CHARGES TRADER WITH INSIDER DEALING

The FCA has charged Damien Frank Clarke, a former equities trader at Schroders Investment Management Limited, with nine counts of insider dealing, contrary to Section 52(1) of the Criminal Justice Act 1993. The charges relate to Mr Clarke's trading in shares and spread bets taken between 30 October 2003 and 28 November 2012. Mr Clarke has been bailed and will attend City of Westminster Magistrates Court in July 2014. In the FCA's press release it states that the FCA is currently prosecuting 7 other individuals for insider dealing offences.

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