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BULLETIN | Financial Services and Regulation

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Welcome to our round up of the last month's news from the financial services sector in the United Kingdom. We have also published a separate edition, packed with financial services news and updates from the European Union, which is available here. The United Kingdom Financial Conduct Authority ("FCA") has been busy publishing guidance on the Remuneration Code for the Alternative Investment Fund Managers Directive ("AIFMD"), and clarifying its supervisory approach to the risk mitigation aspects of the European Markets Infrastructure Regulation ("EMIR"). It has also published some materials on the reporting regime under the Capital Requirements Regulation (part of the Capital Requirements Directive ("CRD IV") reforms) amongst other things. In addition, there has been a good deal of activity with regard to the United Kingdom consumer credit regime, as the deadline for the handover of responsibility from the Office of Fair Trading to the FCA on 1 April 2014 draws nearer. As ever, it has also been a busy month with regard to enforcement: we have seen huge fines being handed to State Street's UK transition management business and to HomeServe Membership Limited for systems and controls errors and conduct failings.

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SPEECHES

1. FCA DISCUSSES INTEGRITY IN RELATION TO PRICE FORMATION

On 3 February 2014, David Lawton, director of markets at the Financial Conduct Authority ("FCA"), spoke at the International Capital Market Association ("ICMA") on the integrity of the price formation process in markets. Mr Lawton explained that the process is key to the functioning of successful and sustainable markets, and to ensuring that markets are fair, efficient and transparent. Fairness in markets, he said, required a reliable price formation process with effective detection and deterrence against improper trading practices and fair access given to investors to market facilities, markets and price information. He said there must also be the correct level of transparency, and the right degree of pre and post trade information available on a real time basis.

Where markets possess a high quality price formation process, he stressed that they aid all participants. Such a process reduces transaction and search costs, as well as building investor confidence, and underpinning deep and liquid markets to raise funds, invest or manage risk. He said this is a goal which regulators across the world are continually working towards. It means that in the case of the FCA, it must assess the markets within the UK constantly, as well as ensuring a harmonised and consistent response across the world in terms of co-ordination. Mr Lawton explained that it had been made even harder due to the pace of change of global regulation, new strategies and new markets technologies.

He also stated that one of the benefits of the FCA being a new body with new objectives and tools was that this had given it the opportunity to look at old problems with a fresh prospective. The new competition objective now offers the FCA a new filter through which to consider price information and market integrity in general. In addition, the FCA's use of behavioral economics is able to bring fresh insights into the problems which face the markets, and it challenges the FCA to consider factors, such as the role of non-rational behavior in price formation. He explained further that work on maintaining the integrity of the price formation process would feature throughout the FCA's market agenda, and this would tie in with international securities regulation.

He said that, over the past decade, technical innovation and regulation (mainly in the form of the Markets in Financial Instruments Directive ("MiFID")) have radically changed the landscape and increased competition in markets. However, increased competition has led to increased search costs and reduced liquidity. Therefore, in order to achieve an optimal price formation process, he explained that a balance is needed between what competition can offer, a reduction in transaction costs and a facilitation of best execution, and the associated risks of fragmentation, increased set costs and reduced liquidity. Regulatory efforts to strengthen price formation in this more decentralised, and over-the-counter age, is currently being driven by reforms known as MiFID II and the revised Market Abuse Directive ("MAD II").

Mr Lawton also touched on the consideration of areas where prices are set completely off market, and which traditionally have not been thought of as part of the price formation process. This includes the commodity markets. He stressed that the importance of off exchange activity is increasingly being recognised. He also mentioned that benchmarks and off exchange mechanisms are areas where the FCA will look to work in order to find future improvements to the price formation process.

UK PUBLICATIONS

1. FMLC PUBLISHES RESPONSE TO FCA CONSULTATION ON CLIENT ASSETS REGIME

The Financial Markets Law Committee ("FMLC") has published a response to the FCA's review of the client assets regime for investment business (CP13/5), published last year. The FMLC response was published on 28 January 2014, and contains feedback on certain aspects of the FCA's consultation paper, including areas of legal uncertainty arising from the proposals in the context of their implications for financial markets. The FMLC provides comments on, and seeks further clarification on, the following:

- records based distribution - in particular, the FMLC states that it seems unlikely that a court would be willing to see a client's proprietary entitlement to money or assets defeated as a result of inaccurate record-keeping. It suggests that the FCA proposals would lead to dispute and challenge and may be perceived as unfair by customers;
- the overlap between the client assets regime, central clearing structures and the European Markets Infrastructure Regulation ("EMIR");
- client reporting and information - the FCA should ensure that reporting and information requirements do not cut across the requirements on public disclosure statements on segregated positions and supporting collateral under EMIR;
- the banking exemption;
- acknowledgement letters - the FMLC requests clarification on how the proposals will apply to entities outside the UK, which are not subject to the same regulatory regime but could receive these letters;
- multiple pools and the identification of beneficiaries; and
- the need to take into account, as part of the review of the client assets regime, the operational realities of the trading of securities and financial markets.

The FMLC, in its conclusion, acknowledges that the far-reaching changes proposed by the FCA are reflective of the need for change that has been highlighted in the light of the Lehman Brothers insolvency. It states that the proposals must be clarified in light of existing European Legislation and other regulations to which they are intended to be complementary. It hopes that a further clarification will be provided by the FCA prior to the final rules being drafted. The final rules are expected sometime in the first half of this year.

2. FCA PUBLISHES MATERIALS ON COREP AND FINREP

Earlier this month, the FCA published a "Dear Head of Compliance" letter which it has sent to FCA regulated firms in relation to the regulatory data required under the new European reporting standards, as required under the Capital Requirements Regulation ("CRR"), known as COREP and FINREP. CRR came into force in the UK on 1 January 2014, and is part of the package of reforms under CRD IV.

The letter was sent out to firms now covered under the Prudential Sourcebook for Investment Firms ("IFPRU"). The purpose of the letter is to identify how firms have prepared for the collection of the data and whether they will be able to submit this data in the correct format. To this end, the letter contained a short "readiness" survey, and the FCA will look to use this information as it works through the final stages of implementation of the new regime. The FCA will review the data and provide further communications and direction to firms if appropriate. Where firms are duel-regulated by both the PRA and FCA, and they have already received similar surveys from the PRA, they will not need to complete this FCA survey. It is understood that the PRA and FCA will work together on the new regime implementation.

The FCA may potentially request some firms to provide extra information on a voluntary basis with regard to their capital position (in relation to the transition from CRD III to CRD IV) as well as their COREP implementation project. It is likely that the FCA will make this request of more prudentially significant firms, or firms which have undergone a material change in their capital position following the implementation of CRD IV. Firms must inform the FCA immediately should they see a significant detrimental shift in their capital because of or during the transition to the new CRD IV requirement. Please note, that the FINREP requirements relating to financial and accounting reporting standards do not come into effect until 1 July 2014.

The FCA has also published a filing manual, which is designed to help firms and software vendors when creating the documentation for the common reporting and financial reporting requirements of the CRR. The manual provides specific guidance for UK firms and sets out rules which are a further clarification of the filing rules provided by the European Banking Authority ("EBA"), published in December 2013.

3. FCA PUBLISHES POLICY STATEMENT ON REFERRALS TO DISCRETIONARY INVESTMENT MANAGERS

The FCA has set out its final rules on referrals to discretionary investment managers and advisor complaints reporting in a policy statement published on 31 January 2014 (PS14/1). The policy statement follows on from the FCA consultation paper containing the draft rules which was published in July 2013 (CP13/4). The FCA has made no changes to the rules as set out in CP13/4 and most respondents to the policy statement were in favour of the proposals. The rules ban new referral payments by a discretionary investment manager to an advisor when the advisor recommends that a client places additional money with the same discretionary investment manager for whom they receive payments following a pre-Retail Distribution Review referral. The rules also ban referral payments where an advisor firm does not provide personal recommendations to particular clients, but provides other services to them.

The policy statement contains a minor amendment to the rules in relation to complaints reporting. The change has been made in order to match the FCA's policy intention that complaints reporting covers all activities of a retail investment advisor, including when such an advisor provides advice on shares and derivatives as well as in relation to retail investment products. All respondents agreed with this proposal and the FCA has stated its intention to go ahead with these changes. However, the final rules on complaints reporting have not been published as yet, since the FCA is holding them back so as to coincide with an update on the text in the GABRIEL reporting system due in June 2014.

4. TRANSITION MANAGEMENT SERVICES IN THE UK UNDER SCRUTINY

The FCA has published a report on its thematic review into the transition management ("TM") service industry in the United Kingdom (TR14/1). The FCA's thematic review followed concerns about the TM industry, especially in relation to possible overcharging and poor conflicts of interest management. Investment banks, custody banks, asset managers and specific specialist firms offer TM to other firms in the financial services industry in order to help them move investment portfolios between different managers or markets, whilst managing market risk and reducing transaction costs.

According to Clive Adamson, FCA Director of Supervision, the TM market deals with over £165 billion of assets in the UK every year and it is an important service for asset owners and to millions of underlying pension fund holders in the UK. The FCA review has provided a high-level look at the size of the sector, the business models operating within it, the levels of oversight, governance and controls at TM firms.

The report highlights that there are 13 TM providers in the UK which dealt with over £165 billion of assets through approximately 700 individual mandates between 2010 and 2012. Because the TM process is complex, it requires careful management in order to avoid potential conflicts of interest. The FCA found that the existing rules and guidance which relate to conflicts of interest, and the conduct of business are clear. However, since TM activity at the majority of firms is low, it does not receive the required level of oversight from senior management and control functions. Also, reports, data and management information provided by TM firms often varied in the level of detail and clarity provided. In many cases there was no internal segregation of duties between those effective the transition and those reporting to the client on performance which led to question marks being placed on the accuracy of such reports.

The final section of the report sets out how the FCA intends to proceed in relation to its supervision of TM, including focusing on the management of conflicts of interest, oversight, governance and controls, transparency and communication, and client understanding. If there were any doubts that the FCA did not mean business in this sector, one need only refer to the recent fine handed down to State Street Bank Europe Limited and State Street Global Markets International Limited for breaches in this area (see Investigations & Enforcement below).

5. Further clarification on the UK supervisory approach to risk mitigation requirements under EMIR

The FCA has provided an update on its website, regarding its supervisory approach to firms which are unable to comply with risk mitigation requirements for non-cleared trades relating to portfolio reconciliation, dispute resolution and compression under the European Markets Infrastructure Regulation ("EMIR"). The FCA has stated on this updated webpage that it expects firms in this position to have a detailed and realistic plan to achieve compliance within "a very short time-frame". Firms must have clear plans in place by 30 April 2014 and be able to demonstrate compliance with the EMIR requirements in relation to risk mitigation after that date.

6. Finalised FCA guidance on the AIFM Remuneration Code

The FCA published finalised guidance (FG 14/2) relating to the AIFM Remuneration Code. The AIFM Remuneration Code is set out in the Senior Management Arrangements, Systems and Controls Sourcebook at Chapter 19B ("SYSC 19B"). The guidance was published on 31 January 2014 and came into force immediately. It is intended for firms authorised as full-scope UK AIFMs under the European Alternative Investment Fund Managers Directive ("AIFMD"). It states that the remuneration regime will apply only to full performance periods following authorisation of the firm, and it will apply from the first full performance period after the firm becomes authorised.

The guidance stipulates that remuneration disclosure must be contained in the relevant AIF's annual report, which must be made available no later than 6 months following the end of the AIF's financial year. The FCA appreciates that items of information relating to remuneration may not be available to the AIFM in respect of the relevant reporting period, and it requests that where a firm lacks relevant information and/or believes such information would not be materially relevant, it could consider omitting such disclosure and explaining the basis for this.

The guidance also covers:

- minimum retention periods;
- treatment of payments to partners or other members of an AIFM;
- treatment of remuneration in the form of units, shares and other instruments; and
- how proportionality should be applied to AIFMs, delegates of the AIFM, AIFM remuneration code staff at an AIFM performing permitted business not involving the management of AIFs and remuneration committees.

CONSUMER CREDIT

1. AML GUIDANCE CONSULTATION FOR CONSUMER CREDIT FIRMS

The Joint Money Laundering Steering Group ("JMLSG") published draft guidance on compliance with anti-money laundering ("AML") obligations for consumer credit firms as a consultation paper. The consultation is dated 29 January 2014, and has been prepared by the JMLSG in preparation for the FCA's takeover of responsibility for supervising consumer credit on 1 April 2014. The consultation inserts a new Chapter 11a for consumer credit firms into Part II of the JMLSG's AML and counter-terrorist financing ("CTF") guidance for the financial services sector.

As with all the sector-specific guidance contained within Part II of the JMLSG guidance, the consultation contains a note that the new chapter should not be read on its own, but in conjunction with the main guidance set out in Part I of the JMLSG guidance. The guidance will cover both unsecured credit providers and secured lenders. The consultation closed on 21 February 2014.

2. FCA PUBLISHES NEW CONSUMER CREDIT WEB PAGES AND INTERIM PERMISSION FORM FOR LOCAL AUTHORITIES

On 14 February 2014, the FCA published a new webpage which sets out how consumer credit firms should prepare for FCA authorisation. More detailed information on authorisation is expected to follow from the regulator in March. The FCA has stated that this will include a breakdown of the application period dates that it will allocate to groups of firms. Copies of the application packs for firms will be available on line from March also. In addition, the FCA has also published a new webpage setting out how the approved persons regime will apply to consumer credit firms. Another new webpage sets out how the appointed representatives regime will apply to consumer credit firms.

The FCA has also published a form for local authorities to use when applying to the FCA if they wish to carry on consumer credit business within the scope of the Consumer Credit Directive ("CCD") on and after 1 April 2014. The form comes together with an explanatory memorandum. This information is in addition to that previously published by the FCA on this subject in January.

3. CONSUMER CREDIT STATUTORY INSTRUMENTS PUBLISHED ONLINE

On 5 February 2014, the Government published finalised versions of two Statutory Instruments relating to the adoption of consumer credit regulation by the FCA from the Office of Fair Trading ("OFT"). The Financial Services and Markets Act 2000 (Consumer Credit) (Miscellaneous Provisions) Order 2014 ("the Order"). The Order amends the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 ("FPO"), the Financial Services (Distance Marketing) Regulations 2004 and the Financial Services and Markets Act 2000 (Regulators Activities) (Amendment) (No 2) Order 2013.

Amongst the amendments covered are provisions for persons to make an application to the FCA for a determination enabling the enforcement of a consumer credit agreement which would otherwise be unenforceable; ensuring that communications made by an employer to an employee in relation to a loan which is an exempt credit agreement are exempt from the general prohibition on financial promotions; replacing references to the OFT with references to the FCA and the Competition and Markets Authority as appropriate. A number of the Order's provisions came into force on 26 February 2014 and the remainder will come into force on 1 April 2014.

The Financial Services and Markets Act 2000 (Appointed Representatives) (Amendment) Regulations 2014 amend the Financial Services and Markets Act 2000 (Appointed Representatives) Regulations 2001, and set out the descriptions of business and kinds of regulated activities which are connected to consumer credit business in relation to the appointed representative exemption in section 39 of FSMA. The regulations also provide for authorised persons who do not have permission to carry on consumer credit business to act as an appointed representative and make use of the exemption.

On 17 February 2014, the Government published the Financial Services and Markets Act 2000 (Consumer Credit) (Designated Activities) Order 2014, which specifies that debt-collecting and entering into, or exercising rights under, a consumer credit agreement will be specified regulated activities under section 23 of the FSMA unless the activity relates to borrowing secured on land. A draft version of this was published on 15 January 2014.

On 24 February 2014, the Financial Services and Markets Act 2000 (Consumer Credit) (Transitional Provisions) Order 2014 was published. This order amends the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013, published in July 2013 to allow for persons holding a consumer credit license to obtain interim permission under the Financial Services and Market Act 2000. It also provides a procedure whereby persons whose consumer credit licenses are subject to suspension prior to 1 April 2014 are able to obtain interim permission where they launch a successful appeal against the suspension. It also makes amendments to the provisions on specific enforcement and disciplinary notices.

All four of these statutory instruments have been published with accompanying explanatory memoranda.

INVESTIGATIONS AND ENFORCEMENT

1. FIRST FCA WARNING NOTICES PUBLISHED

The Financial Conduct Authority ("FCA") has this month issued two warning notices under the new powers it was given by the Financial Services Act 2012 to promote transparency in enforcement proceedings. These notices are the first to be issued by the FCA following the publication of its policy statement (PS13/9) on warning notices in October 2013.

Warning notice statement 14/1 publishes information on an individual who was a "submitter" at a bank, and who, over a period of two years, was knowingly concerned in the contravention of Principle 5 of the FCA's Principles for Businesses ("PRIN") by the bank for significant failings in relation to an interest rate benchmark. The FCA also published, amongst other things, the fact that it believes the individual to have colluded with an interdealer broker acting on behalf of a trader from another bank, by making interest rate benchmark submissions which took into account a request made by that broker. He is also believed to have colluded directly with other traders at other banks.

Warning notice statement 14/2 publishes information on an individual, who was a manager of a bank, and who, over a period of three years, was knowingly concerned in the breaching of Principles 3 and 5 of PRIN by the bank for significant failings relating to the use of an interest rate benchmark. The FCA also states in the notice that it believes the individual was responsible for the oversight and supervision of the bank's submitters and some of the traders. He failed to manage the business area for which he had responsibility and was aware that there were insufficient systems and controls in place to manage interest rate benchmark submsissions.

Both of the warning notices make it clear that they are not final decisions and that each individual has the right to make representations to the Regulatory Decisions Committee at the FCA (the "RDC"). The RDC will then decide whether to issue a decision notice.

2. HOMESERVE MEMBERSHIP LIMITED HANDED LARGEST CONDUCT FINE FOR "SERIOUS" AND "SYSTEMIC" FAILINGS

An insurance intermediary, HomeServe Membership Limited ("HomeServe"), which sells home emergency and repairs cover, has been fined £30,647,400 by the FCA for breaches of Principles 3, 6 and 7 of its Principles for Businesses, in what it calls "serious, systemic and long running failings" within numerous sectors of its business. The FCA has stated in its press release announcing the fine, that it is the largest ever handed down to a firm for retail conduct failings. The FCA considers the failings to be of particular magnitude, given that a majority of HomeServe's customers are of retirement age.

According to the Final Notice, the FCA found that, between January 2005 and October 2011, HomeServe failed to embed a culture which took compliance and the FCA's initiative on Treating Customers Fairly ("TCF") seriously. The breaches to the Principles occurred through:

- incentivising volume over quality in relation to sales;
- incentivising staff, via an inappropriate remuneration structure, to deal with complaints by closing as many as of these as possible;
- failing to ensure that senior management undertook adequate regulatory training for a period of more than three years, which led to a risk that customers would not be treated fairly and a failure by senior management to identify and address key issues;
- insufficient engagement by the board with compliance issues, including failure to address compliance monitoring which raised mis-selling as a problem;
- inadequate IT software and testing of IT systems, which meant that HomeServe failed to notice pricing calculation errors and duplications.

HomeServe has accepted that it must restore the customer to the heart of its business and to move away from a profits-driven culture. The firm has voluntarily ceased new sales and marketing, as well as strengthening its board. It was also given a 30 per cent discount on the fine figure, having agreed to settle the matter at an early stage.

3. STATE STREET FINED FOR TRANSITION MANAGEMENT FAILINGS

The FCA has published a Final Notice in relation to a £22,885,000 fine it has imposed on State Street Bank Europe Limited and State Street Global Markets International Limited (together "State Street UK") for failings in its transition management business. The failings led to breaches of Principles 6, 7 and 3 of the FCA's Principles for Businesses.

According to the Final Notice, between June 2010 and September 2011, State Street UK developed a strategy to charge substantial mark-ups on specific transactions over and above the agreed commissions or management fees. During this period it allowed a culture to develop within the firms which prioritised revenue generation over treating their customers fairly. When one client alerted State Street UK to the overcharging, it was claimed by senior managers that this was inadvertent and further mark-ups in the same transaction remained undisclosed.

State Street UK deliberately misrepresented its earnings from particular transactions, specifically with regard to pre-trade estimates and post-trade reporting, and, therefore, failed to communicate with clients in a clear, fair and not misleading manner. In addition, it did not have adequate risk management systems in place for its transition management business and there was a lack of challenge and oversight from senior management in this area.

The FCA was particularly concerned because State Street UK's clients include large investment management firms and pension funds, which hold investments on behalf of retail investors. Therefore, in the FCA's opinion, the actions of State Street UK in the wholesale market caused "a risk of serious detriment to retail investors". However, the FCA also stated that once senior management became aware of the issues, it took quick action to investigate the problems and to put in place a comprehensive remediation programme. Since State Street UK agreed to settle at an early stage, it qualified for a 30 per cent discount to the fine figure of £32,692,800. The FCA also stated that firms "should be in no doubt that the spotlight will remain on wholesale conduct."

4. SFO AND DPP PUBLISH CODE OF PRACTICE FOR DEFERRED PROSECUTION AGREEMENTS

On 14 February 2014, the Serious Fraud Office ("SFO") and the Director of Public Prosecutions ("DPP") issued a code of practice in relation to their use of deferred prosecution agreements under the Crime and Courts Act 2013. They had previously consulted on the matter in June of last year. Agreements of this type enable the SFO and DPP to suspend prosecutions for a defined period where the organisation or individual concerned meets specific conditions and the alleged offences relate to economic crime.

Prosecutors should refer to the code of practice when negotiating agreements with persons whilst looking to prosecute for offences under the Crime and Courts Act 2013. They should also review the code when applying to the courts for the approval of an agreement, or when overseeing an agreement once it has been approved. The code of practice covers the factors which prosecutors should take into account when considering whether to enter into an agreement with a person, and how they should use information which they have received during the agreement's negotiation period. It also refers to terms in the agreements, financial penalties, breaches and publication of decisions. Agreement of this kind have been available for use by the SFO and DPP since 24 February.

5. HIGH COURT RULES INVESTMENT SCHEMES ARE UNAUTHORISED COLLECTIVE INVESTMENT SCHEMES

On 17 February 2014, the High Court ruled that Capital Alternatives and various other firms were together promoting and operating two investment schemes which were collective investment schemes. None of the firms concerned had the requisite permissions from the FCA to operate and promote such schemes. The defendants had attempted to structure their schemes so as to avoid the need for regulation, but the High Court agreed with the FCA that the schemes did in fact constitute unauthorised collective investment schemes.

Tracey McDermott stated in the FCA's press release on the case, that "even if operators have deliberately tried to structure their scheme to avoid regulation, the court will still look at whether those operating the scheme should in fact be regulated for consumer protection."

Given the ruling, the court may order the defendants to pay compensation which can be passed onto investors. It also granted leave to appeal to the defendants in relation to certain aspects of the case, which means that the FCA will have to wait until any appeal is heard before it is able to proceed with obtaining rulings from the High Court on the outstanding aspects of the case.

If you have any questions concerning the material discussed in this bulletin, please contact the following members of our financial regulation practice group:

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