FINANCIAL SERVICES REGULATION
Exchange – International Newsletter

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DLA PIPER

INTRODUCTION

WELCOME

DLA Piper's Financial Services International Regulatory team welcomes you to the twenty-sixth edition of 'Exchange – International' – an international newsletter designed to keep you informed of regulatory developments in the financial services sector.

This issue includes updates from the EUROPEAN UNION, as well as contributions from AUSTRALIA, the MIDDLE EAST, the NETHERLANDS, SPAIN, the UK and the USA.

Our aim is to assist you in providing an overview of developments outside your own jurisdiction which may be of interest to you. In each issue we will also focus on a topic of wider international interest. In this edition, "In Focus" looks at the proposed second EU payment services directive (PSD II), set to be adopted in the coming months.

In addition, we look at the recent General Court ruling against the ECB in favour of the UK in relation to location requirements for central counterparties for securities clearing transactions; draft EBA Guidelines on limiting banks' exposures to shadow banking entities; the EU Commission's vision of a Capital Markets Union; Deutsche Bank AG's £227 million fine for LIBOR manipulation; crowdfunding in the Netherlands; and recent clarification to the Volcker Rule's "Solely outside the United States" covered fund exemption.

Please click on the links below to access updates for the relevant jurisdictions.

Your feedback is important to us. If you have any comments or suggestions for future issues, we would be very glad to hear from you.

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EUROPEAN UNION

COURT RULES IN FAVOUR OF THE UK AGAINST THE ECB ON LOCATION OF CENTRAL COUNTERPARTIES FOR CLEARING OF SECURITIES TRANSACTIONS

On 4 March 2015, the General Court (**Court**) annulled the ECB's Eurosystem Oversight Policy Framework (**Policy**) dated 5 July 2011 insofar as it stated a requirement for central counterparties (**CCPs**) above a certain threshold and involved in the clearing of securities to be located within the Eurozone area. The UK, supported by Sweden, sought an order annulling the Policy. The ECB, supported by Spain and France, opposed the annulment sought. The full judgment can be read here.

The UK contended that the ECB had no competence to regulate the location of CCPs under EU law and therefore the location requirement in the Policy should be annulled. The ECB argued that it had competence to regulate the location of CCPs involved in the clearing of securities pursuant to its objective to promote the smooth operation of payment systems under Article 127(2) of the Treaty on the Functioning of the European Union (**TFEU**), and its power to make regulations to ensure efficient and sound clearing and payment systems within the EU conferred by Article 22 of Protocol No.4 to the FEU Treaty on the Statute of the ESCB and the ECB (**Statute**).

As part of the process of clearing securities transactions, the CCP takes the place of both the buyer, who provides liquid assets for the purchase of the securities, and the seller, who transfers the securities that are the subject of the transaction. As such, the Court determined that such a transaction can be divided into a "cash leg" and a "securities leg". The "cash leg" of a clearing operation involves the payment of funds in consideration for the securities to be transferred and would fall within the definition of a "payment system". However, the "securities leg" of a clearing operation (i.e. the transfer of the securities) does not involve a payment of funds and hence was held not to constitute a "payment" for the purposes of the relevant provisions of the TFEU and the Statue. The ECB's power to adopt regulations was deemed to relate to payment clearing systems alone and not to securities clearing systems. Therefore, the ECB did not have competence to require CCPs to be located within the Eurozone.

The ECB also contended that the Policy was not capable of annulment by the Court on the basis that the Policy was merely a policy statement from the ECB and not a document capable of having legal effect. However, the Court ruled that based on the wording, context and substance of the Policy, along with the intention of the ECB in publishing the Policy, the Policy would have reasonably been perceived as having legal effect and hence was capable of being of challenged before the Court.

The Court annulled the sections of the Policy that relate to location requirements of CCPs.

EBA PUBLISHES DRAFT GUIDELINES ON LIMITS ON EXPOSURES TO SHADOW BANKING ENTITIES

Introduction

On 19 March 2015, the European Banking Authority (**EBA**) published a consultation paper on draft EBA Guidelines (**Guidelines**) on limits on exposures to shadow banking entities (**Consultation Paper**). Under Article 395(2) of the Capital Requirements Regulation (No. 575/2013) (**CRR**), the EBA is required to issue guidelines to set limits on the exposure of credit institutions and investment firms (together **Institutions**) to shadow banking entities that carry out banking activities outside a regulated framework. The EBA's consultation on the Guidelines is open until 19 June 2015, with the intention of the Guidelines being implemented by the end of 2015.

Concerns about shadow banking

Despite providing certain benefits, shadow banking entities are considered to pose certain risks to Institutions and the financial system as a whole. The Guidelines require Institutions to set certain limits on their exposures to shadow banking entities through their own internal processes. Each Institution will have to set limits (i) in relation to its exposures to each shadow banking entity to which it is exposed and (ii) on its aggregate exposure to the shadow banking sector as a whole.

Shadow banks are considered inherently risky as they carry out banking activities without being subject to any prudential regulation (or without being subject to

the same level of prudential regulation as Institutions), do not provide access to deposit guarantee schemes and do not have access to central bank liquidity. Furthermore, shadow banks are considered particularly vulnerable to run risk and liquidity problems, the latter of which are also exacerbated by their ability to engage in highly leveraged or risky activities.

There are also concerns that, in order to seek profits, Institutions may seek to circumvent rules and regulation by funding shadow banking entities that undertake bank-like activity. This could lead to core banking activity migrating away from the regulated banking sector and into the shadow banking sector. These concerns are the justification for limiting Institutions' aggregate exposure to shadow banking entities.

EBA definition of "shadow banking"

Broadly, the Guidelines define shadow banking entities (a definition not contained in the CRR) as entities that:

- carry out credit intermediation activities, defined as bank-like activities involving: (i) maturity transformation (borrowing short and lending on longer timescales), (ii) liquidity transformation (using highly liquid assets to purchase less liquid assets), (iii) leverage and (iv) credit risk transfer; and
- are not within the scope of prudential consolidation or subject to solo prudential requirements under specified EU legislation.

The definitions contained in the Guidelines aim to capture entities that carry out bank-like activities but are not subject to appropriate prudential supervision and therefore pose the greatest risks to Institutions and the financial system. Funds will generally fall within the definition of a shadow banking entity. However, certain funds that are subject to prudential regulation will fall outside of scope of the Guidelines, i.e. funds that are regulated under the Undertaking for Collective Investment in Transferable Securities (**UCITS**) Directive (**UCITS Directive**), as well as third-country funds subject to equivalent regulation. However, this exemption will not apply to any money market funds, regardless of whether they are regulated under the UCITS Directive. This is because the average size of a money market fund far exceeds the average size of a UCITS fund and as such the systemic risks posed by money market funds are greater.

Obligations on Institutions

The Guidelines, as drafted, will place the following requirements on Institutions.

- **Processes and control mechanisms**

  Institutions will be required to identify and assess individual exposures to shadow banking entities and risks arising from those exposures. Institutions will have to put in place an internal framework for the identification, management, control and mitigation of such risks, set a risk appetite for exposures to shadow banking entities, and implement a process for determining the interconnectedness between the shadow banking entities to which the Institutions are exposed, as well as between shadow banking entities and the Institutions themselves.

- **Aggregate limit on exposure to shadow banking entities**

  Each Institution will be required to set an aggregate limit on its exposures to the shadow banking sector as a whole relative to its eligible capital, taking into account its business model, risk appetite in respect of the shadow banking sector and existing exposure to shadow banking entities.

- **Individual limits on exposures to shadow banking entities**

  Each Institution will also be required to set limits on its exposures to each individual shadow banking entity, taking into count in relation to each entity whether the entity is subject to prudential or supervisory requirements, the entity's financial position, information on the portfolio of the entity, and whether the entity is vulnerable to asset price or credit quality volatility.

- **Oversight by management**

  Management will have to review and approve the relevant Institution's risk appetite for exposure to individual shadow banking entities, as well as

aggregate and individual limits. Management will also have to review the risk management process to manage exposure to shadow banking entities and ensure the setting of limits on exposures contemplated by the Guidelines is clearly documented.

- **Fallback Provision**

  Institutions that are unable to determine appropriate limits on exposures, whether due to a lack of information about the activities of shadow banking entities to which they are exposed, or due to having a lack of ability to analyse such information, should apply a limit of 25% of their eligible capital to their aggregate exposures to shadow banking entities.

Competent authorities and Institutions must make "every effort" to comply with the Guidelines pursuant to Article 16(3) of the EBA Regulation.

CAPITAL MARKETS UNION – COMMISSION GREEN PAPER

On 18 February 2015, the European Commission (**Commission**) published a green paper: *Building a Capital Markets Union* (**Green Paper**), in which it restates its aim of establishing a single market for capital across the EU (**Capital Markets Union**).

The Commission's purpose for establishing a Capital Markets Union is to unlock and strengthen investment in the EU for the long term. In the Green Paper, the Commission observes that European businesses are heavily reliant on the banking sector and less on capital markets compared to businesses in other parts of the world. The Commission considers that developing the EU's capital markets would make the EU financial system more stable by reducing businesses' reliance on banks, attracting more investment from outside of the EU and unlocking more investment for all companies, in particular small and medium-sized enterprises (**SMEs**).

The Green Paper sets out detail on each of the following areas that the Commission considers key to the development of a Capital Markets Union:

- Developing of a high-quality securitisation market, in order to free up bank balance sheets and facilitate more bank lending
- Reviewing the Prospectus Directive to allow smaller firms in particular to raise funding in the capital markets and reach international investors
- Improving the availability of credit information on SMEs to encourage investment in such undertakings
- Establishing a pan-European private placement regime
- Encouraging new European long term investment funds to channel investment into infrastructure and other long term projects

The Green Paper considers how European capital markets are currently structured and analyses some of the barriers to more integrated capital markets. The Green Paper goes on to seek views on the Commission's proposed steps and on the wider barriers to access to finance and diversification of sources of finance within the EU.

The Commission states that it intends to have a framework in place for a fully functioning Capital Markets Union by 2019.

FOURTH MONEY LAUNDERING DIRECTIVE NEARS ADOPTION

On 20 April 2015, the Council of Europe (**Council**) adopted the Fourth Money Laundering Directive (**MLD4**) and the Wire Transfer Regulation (**WTR**). This will allow the European Parliament to adopt MLD4 and WTR, which is expected to occur during the European Parliament's plenary session between 18 and 21 May 2015. After the texts have been adopted by the European Parliament, they will be published in the Official Journal of the European Union and become law. Each Member State will then have two years to implement the provisions of MLD4 through national legislation. The WTR has direct effect and as such will automatically become law in each Member State.

The European Commission put forward proposals for MLD4 in order to update and enhance the existing anti-money laundering (**AML**)/counter-terrorist financing (**CTF**) framework prescribed under the Third Money Laundering Directive, which was passed in 2005, and to implement the Financial Action Task Force's (**FATF**) February 2012 AML and CTF standards.

Some of the key changes that will be made to the AML/CTF regime by MLD4 include:

- Widening the scope of the regime to include a broader range of transactions, including requiring customer due diligence to be applied to persons carrying out cash transactions of EUR 7,500 or more where trading in goods (the current threshold is EUR 15,000);
- Tightening the rules on customer due diligence;
- Requiring corporate entities established within Member States to hold accurate information on their beneficial ownership and trustees to disclose their status and information on underlying beneficial ownership;
- Removing provisions allowing exemptions for certain aspects of customer due diligence in respect of third countries that are considered to have AML/CTF systems equivalent to those in the EU;
- Requiring Member States to adopt a risk-based approach to addressing the threat of AML and CTF by identifying, assessing, understanding and mitigating the risks they face in respect of AML/CTF.

COMMISSION CONSULTS ON ITS REVIEW OF THE PROSPECTUS DIRECTIVE

The Commission published a consultation document on its review of the Prospectus Directive (**Consultation**) on 18 February 2015.

The Commission is required to review the application of the Prospectus Directive by 1 January 2016, but has brought the review forward as it is considered a key feature of establishing a Capital Markets Union across the EU. The objective of the review is to reform the prospectus regime in order to make it easier for companies to raise capital throughout the EU without compromising on effective levels of investor protection.

The Commission restates the two key objectives of the Prospectus Directive which are: (i) to provide investor and consumer protection by ensuring that investors are provided with all of the information necessary to them to make an informed assessment of an issuer and the securities being offered; and (ii) to provide market efficiency to ensure companies can access capital markets across the EU by requiring a common form and content of a prospectus and introducing an EU-wide passporting regime.

Under the Prospectus Directive, a prospectus must be made available to the public when a company makes an offer to the public, or an admission to trading on a regulated market, of transferable securities, within the EU. As a company is usually unable to access funding in the capital markets without preparing a prospectus, the Commission is keen to ensure that the requirements of the Prospectus Directive are no more onerous than strictly necessary.

The Commission sets out a number of potential shortcomings of the Prospectus Directive, which are set out as follows:

- Preparing a prospectus is perceived as expensive, complicated and time consuming
- The requirement to produce a prospectus arises in different circumstances across the EU
- Prospectus approval procedures are handled differently between Member States
- Prospectuses have become overly long documents

In the Consultation, the issues raised by the Commission are split into the three categories below.

- **When a prospectus is needed**

  The existing thresholds before a prospectus is required are considered, including the exemptions that apply to issues offered to 150 persons or less, or issues of notes in denominations of EUR 100,000 or more. One possibility may be raising the thresholds so that fewer issuers are required to issue a prospectus.

- **Information that a prospectus should contain**

  The Consultation contains questions on the effectiveness of the proportionate disclosure regime under the existing Prospectus Directive, which was introduced in order to provide a lighter prospectus regime for certain types of issues and issuers but does not appear to have had its intended effect. The Commission also seeks views on whether there should be a simplified prospectus regime for SMEs and companies with reduced market capitalisation, whether

the introduction of a maximum length to a prospectus would be favourable and the effectiveness of the existing liability and sanctions regime.

- **How prospectuses are approved**

  The Commission seeks further information on the different ways in which national competent authorities assess draft prospectuses submitted to them for approval, as well as views on whether the process should be streamlined and/or made more transparent. Submissions are invited on the efficiency of the EU passporting mechanism for prospectuses. The Commission also seeks views on whether an equivalence regime should be established in the EU for third country prospectus regimes.

COMMISSION CONSULTS ON SIMPLE, TRANSPARENT AND STANDARDISED SECURITISATION

On 18 February 2015, the Commission issued a consultation document (**Consultation**) on a prospective EU framework for simple, transparent and standardised securitisations. This follows the publication of a discussion paper on 14 October 2014 by the EBA on the same topic (**EBA Paper**).

The Commission considers the development of a high-quality securitisation market to be a building block of the Capital Markets Union and would contribute to its objective to return to sustainable economic growth and job creation. The Commission recognises the importance of securitisation as a means of relieving pressure on bank balance sheets and releasing capital for further lending. A strong securitisation market would also diversify sources of funding in the EU and allocate risk efficiently within the financial system. The Commission observes that unlike in the United States, EU securitisation markets have remained subdued since the beginning of the financial crisis, despite realised losses on EU-issued instruments having been low compared to those issued in the United States.

In an attempt to revive the EU's stagnant securitisation markets, it is proposed that a legislative framework is established, whereby "qualifying" securitisations, which are "high-quality" securitisations defined by their simplicity, transparency and standardisation, will receive more generous regulatory treatment than other securitisations, including in terms of capital treatment. These "qualifying" securitisations will for the most part be defined as "high-quality" in terms of the process by which they are created and the structure that they take, rather than in terms of the credit quality of underlying assets (although if the approach suggested in the EBA Paper is adopted, "qualifying" securitisations will also meet certain minimum criteria in terms of credit quality).

In the Consultation the Commission invites input on a wide range of issues including:

- The criteria that should be applied in determining "qualifying" securitisations
- Whether current risk retention rules should be adjusted for "qualifying" instruments
- The expected impact of standardisation of the structuring of instruments on the EU securitisation markets
- The balance to be struck between the amount of high-quality information required by investors and the streamlining of disclosure obligations for issuers/originators
- Whether existing capital requirements under the Capital Requirements Regulation adequately reflect the risks attached to securitised instruments
- How rules on capital requirements should differ between "qualifying" securitisations and other securitisation instruments
- How the institutional investor base for EU securitisation could be expanded

The deadline for comments on the Consultation is 13 May 2015. The Consultation forms part of the Commission's wider work on building a Capital Markets Union.

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AUSTRALIA

REVIEW OF CARD PAYMENTS REGULATION

Following consideration by the Payments System Board at its February meeting, the Reserve Bank of Australia has released an Issues Paper to commence a review of the regulatory framework for card payments.

The review follows a recommendation in the Final Report of the Financial System Inquiry (FSI) that the Board consider a range of measures related to card payments regulation, particularly in relation to interchange fees and surcharging. Some of the FSI recommendations relate to issues where the Bank and the Board have previously noted some concerns about recent developments.

The Issues Paper, Review of Card Payments Regulation, seeks industry and stakeholder views on the regulation of card payments and discusses a number of possible options.

The Board recognises that a review of regulation involves complex issues, and that some potential reforms would need an extended period for consultation and implementation. Accordingly, the paper also invites submissions identifying possible actions to improve the effectiveness of the Bank's regulations, particularly in relation to surcharging, that could be implemented on a faster timeline. The Board will also consider any submissions on card payments regulation made in response to the current Government consultation on the FSI recommendations.

Waiver of Interchange Benchmark Recalculation

The Board has also made a decision on the calculation of the interchange fee benchmarks applying to designated card schemes. In light of the review of card payments regulation and to ensure that it does not impose unnecessary compliance obligations, the Bank will waive the recalculation of the benchmarks that would otherwise be required by 30 September 2015. Accordingly, the obligation to comply with the Bank's interchange fee standards as of 1 November 2015 will be based on the current benchmark levels.

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THE MIDDLE EAST

DEUTSCHE BANK FINED US$8.4 MILLION BY DUBAI REGULATOR

The Dubai International Financial Centre (**DIFC**) branch of Deutsche Bank AG (**Deutsche Bank**) has been fined US$8.4 million by the Dubai Financial Services Authority (**DFSA**) as set out in a decision notice dated 29 March 2015.

The DFSA fined Deutsche Bank for:

- Providing misleading information to the DFSA;
- Failing to comply with AML and conduct of business requirements in respect of certain clients of Deutsche Bank; and
- Failing to have in place adequate governance, systems and controls and compliance arrangements to meet regulatory requirements.

The decision notice followed an investigation into Deutsche Bank by the DFSA in respect of activities carried out by the bank between January 2011 and January 2014. The investigation was launched after it was suspected that Deutsche Bank was failing to classify certain customers as clients of the DIFC branch in breach of DFSA rules.

The investigation confirmed that Deutsche Bank's private wealth management business had been advising on financial products and credit, and arranging credit and deals in investments, whilst failing to classify a number of customers receiving those services as clients, despite DFSA rules prescribing that the provision of such services requires such classification. Instead, Deutsche Bank had been classifying those customers as clients of the booking locations where the relevant transactions were executed, each of which were other Deutsche Bank group branches or entities. In failing to classify customers appropriately, Deutsche Bank had deprived them of certain regulatory protections.

It was further revealed that certain Deutsche Bank employees had represented expressly to the DFSA that the DIFC branch had been merely referring and introducing customers to other parts of the Deutsche Bank group, activities which do not trigger the requirement to classify customers as clients.

As a result of inappropriate classification, Deutsche Bank failed to comply with certain Conduct of Business requirements and AML requirements in relation to a number of customers.

Contrary to DIFC AML rules, Deutsche Bank failed to:

- Subject customers to customer identification and verification in the DIFC;
- Subject customers to an AML risk assessment in the DIFC;
- Ensure that its records were held in accordance with AML rules;
- Establish and maintain effective AML policies, procedures, systems and controls to prevent opportunities for money laundering in relation to its activities;
- Ensure its employees complied with the requirements of its AML systems and controls;
- Review the effectiveness of its AML systems and controls.

The DFSA decision notice further criticised Deutsche Bank for failing to have:

- Adequate systems and controls in place to ensure that it complied with DIFC legislation;
- Adequate resources to conduct and manage its affairs, including financial and system resources as well as adequate and competent human resources; or
- A corporate governance framework in place adequate to promote the sound and prudent management and oversight of its business and to protect the interest of its consumers and stakeholders.

The DFSA has imposed a number of directions in relation to Deutsche Bank's governance systems and controls. In the decision notice, the DFSA acknowledged that Deutsche Bank had already made certain improvements in this regard. No clients were found to have suffered an actual loss as a result of the acts and omissions of Deutsche Bank.

The US$8.4 million fine is the largest ever imposed in the DFSA's ten-year history. The limits of the fines that the DFSA can impose were increased in 2014. Almost half of the total fine amount is attributable to Deutsche Bank's concealing of information, which mislead the DFSA.

THE NETHERLANDS

CROWDFUNDING – PROPOSED AMENDMENTS TO DUTCH LEGISLATION

The Netherlands Authority for the Financial Markets (**AFM**) stated in its recent report 'Crowdfunding – Towards a sustainable sector' that the crowdfunding sector is developing rapidly. In 2014, 24 crowdfunding platforms were added to the AFM's registers and the financial size of crowdfunding has doubled to €37 million compared to 2013.

The AFM has taken the opportunity to look more closely at the supervisory regime of this growing market, and concluded that current legislation and regulation do not sufficiently accommodate sustainable and responsible growth of the crowdfunding sector. Accordingly, the AFM proposed a number of recommendations to adjust the current legislation. Based on these recommendations, the Dutch government published a consultation paper (*Consultatie Wijzigingsbesluit financiele markten 2016*) to introduce an appropriate supervisory regime for crowdfunding. The consultation paper proposes the following key changes:

Ban on inducements for investment firms

If a crowdfunding platform is involved in raising capital via the issuance of financial instruments (e.g. bonds or equity), such a platform may qualify as an investment firm within the meaning of the Markets in Financial Instruments Directive (**MiFID**). This is due to the fact that the crowdfunding platform is likely to provide the service of transmission of orders in financial instruments.

If the crowdfunding platform qualifies as an investment firm, the Dutch ban on commission payments is likely to apply to the crowdfunding platform. As a result, the crowdfunding platform would not be allowed to charge a fee from their clients related to transmission of the order. Needless to say, this entails a significant restriction on crowdfunding platforms, as such fees often form the most important source of income.

In the explanatory memorandum accompanying the consultation paper, the Dutch government states that the ban on inducements could be an imperative restriction for crowdfunding platforms which qualify as an investment firm. According to the Dutch government, this justifies an exemption to the ban on commission payments for crowdfunding platforms which qualify as an investment firm. The consultation paper introduces this exemption.

To prevent improper use of the aforementioned exemption, the Dutch government proposes the following additional conditions to make sure that the exemption aligns with the nature of crowdfunding and not with other services:

- The exemption applies only to crowdfunding platforms that "receive and forward, in the pursuit of a profession or business, client orders with regard to financial instruments" (and not in relation to other MiFID services which fall under the scope of the ban on commission payments);
- The provision of service applies only to financial instruments that are not concluded on a regulated trading platform such as a regulated market;
- The financial instruments involved are offered by the company itself, to make sure that the exemption does not apply equally to the secondary market of issued securities; and
- If a crowdfunding platform wishes to make use of the exemption, it needs to inform the AFM about the intention to perform services that are subject to the exemption.

Reinforcement of the exemption regime for intermediation in callable funds

In the Netherlands, a prohibition applies to (intermediate in) attracting, receiving or holding callable funds from the public (the **Prohibition**). Lending based crowdfunding platforms most often fall within the scope of the Prohibition. However, it is possible to apply for an exemption from the Prohibition (the **Exemption Regime**). Most crowdfunding platforms have hence applied for and obtained such exemption.

The AFM and the Dutch government are of the opinion that the current Exemption Regime is too lenient, and that certain additional requirements should be added in the areas of properness, business conduct and certain prudential requirements.

Accordingly, the Dutch government proposes that more ongoing statutory obligations are applicable to crowdfunding platforms making use of the Exemption

Regime. A crowdfunding platform that wants to rely on the Exemption Regime must comply with, among others, the following requirements:

- day-to-day policymakers of crowdfunding platforms should be tested on suitability;
- employees of crowdfunding platforms should be reliable;
- crowdfunding platforms must ensure that proper administration and financial settlement of projects is guaranteed in a situation in which the platform ceases to operate (for instance due to bankruptcy);
- crowdfunding platforms must ensure that proper procedures are in place related to the handling of incidents;
- crowdfunding platforms must inform the AFM of any incidents; and
- crowdfunding platforms should have an internal complaints procedure, aimed at prompt and careful handling of complaints.

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SPAIN

ISSUES OUTSTANDING OF THE ALTERNATIVE INVESTMENT FUNDS MANAGERS DIRECTIVE (AIFMD)

On 14 February 2015, the Royal Decree 83/2015 was published in the Boletín Oficial del Estado (**BOE**), amending Law 35/2003 of 4 November on collective investments (the **CIS Act**). The publication means, at least theoretically, that the implementation of Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011, in respect of the Alternative Investment Funds Directive (**AIFMD**), in Spain is complete.

Just over three months have passed since the publication of the Royal Decree, however AIFMD raises a number of questions which require further clarity from the legislator and/or regulator in the near future. Topics which have been left wide open focus mainly on alternative investment funds and, specifically, closed-end collective investment funds, which were introduced in the recent Law 22/2014, of 12 November 2014 (amending the CIS Act) which seeks to regulate capital-risk entities and other closed-end collective investment entity types. Three issues seem particularly relevant, and these are set out below.

Firstly, the definition of an "Alternative Investment Fund" (**AIF**) in Article 4.1 a) of AIFMD remains very broad, despite the efforts of the European Securities and Markets Authority (**ESMA**) to narrow the definition in its August 2013 guidelines. The broad definition of an AIF is causing problems for stakeholders in analysing whether or not certain investment vehicles fall within the scope of AIFMD, which in turn has consequences both in respect of management and their commercialisation.

On February 18, 2015, the European Commission published the Green Paper on the Capital Markets Union, which aims to build a single capital market in the EU by 2019. At the same time, the European Commission published a consultation document on reforms to introduce a harmonised European framework for securitisation. It is striking that in that document the Commission itself raises the possibility of adjustments to AIFMD. Although AIFMD excludes from its scope special purpose vehicles for securitisation (and so does our legislator by excluding securitisation funds from the scope of Act 22/2014), certain investment structures that are not securitisation vehicles fall within the definition of AIF, despite having more in common with securitisations than with alternative investments. It would be good to take advantage of this new European legislative initiative regarding capital markets to improve on the definition of what is and what is not an AIF.

Secondly, particular attention is being paid domestically to the exclusion from the scope of Law 22/2014 of Sociedades Anónimas Cotizadas de Inversión en el Mercado Inmobiliario (**SOCIMIs**). This exclusion, which is very reasonable from the perspective of promoting investment through this tax efficient vehicle, does not avoid the barriers which arise when marketing shares in SOCIMIs in other jurisdictions within the European Union. Vehicles which are analogous to SOCIMIs in other jurisdictions (such as REITs) have not been excluded from the scope of AIFMD when the directive has been implemented into the law of other member states. Therefore, it is necessary to analyse in those jurisdictions where they intend to market shares in SOCIMIs if marketing is permitted, either because the vehicle is not considered as an AIF in that jurisdiction, or because the law of that state recognises, for the purposes of marketing, the exception made by the Spanish legislature. In any case, in the prospectus of any SOCIMI it is strongly recommended to include "selling restrictions" and appropriate risk factors in relation to AIFMD.

Finally, it is important to highlight another aspect of AIFMD which requires further definition; the introduction of the role of depositaries of venture capital entities and closed-collective investment entities. According to its business plan for this year, the CNMV will release in the second quarter of 2015, a Circular to determine the specifics and exceptions applicable to the depositaries of such entities, developing, amongst other things, the technical aspects of depository and surveillance functions, control over cash flows duties in connection with the calculation of net asset value and valuation of shares and the liability regime. However, until the CNMV Circular is actually released, the management companies of closed-ended collective investment funds (new name given by the Act 22/2014 to companies managing venture capital) that have to appoint a depositary must review their operations and procedures and integrate the two, and coordinate with the depositories designated for the latter in order to comply with the functions assigned to them by the legislator.

In conclusion, AIFMD is a regime that still requires practical adjustments and certainly requires a sufficient period of effective implementation. Once the implementation of AIFMD has been analysed over the coming years, we will be able to judge whether it has met its objectives or if, on the contrary, it is necessary to introduce changes at European and national level to remedy possible gaps or inefficiencies.

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UNITED KINGDOM

REGULATORY DEVELOPMENTS

FCA SETS OUT APPROACH TO SOCIAL MEDIA AND CUSTOMER COMMUNICATIONS

On 13 March 2015 the Financial Conduct Authority (**FCA**) published FG15/4: Social media and customer communications (**Guidance**), a finalised guidance document which sets out the FCA's position on the types of social media communications that constitute financial promotions and hence fall within scope of the FCA's regulatory powers. The Guidance sets out a broad and non-exhaustive list of the types of websites and applications that fall within the definition of "social media", including blogs, microblogs (e.g. Twitter), social and professional networks (e.g. Facebook, LinkedIn, Google+), fora and image- and video-sharing platforms (e.g. YouTube, Instagram, Vine, Pinterest). The Guidance contains illustrative examples of compliant and non-compliant social media communications. Some of the significant issues addressed in the Guidance are summarised below.

Capacity of Communicator: The FCA confirms that its regulatory powers only apply to communications made "in the course of a business" and not by an individual in his or her personal capacity. Where an individual closely associated with a business makes a communication through social media, it should be made clear that the communication is not made in the course of that business.

Unintended Recipients: Social media communications can quickly reach a large number of unintended recipients. Businesses should ensure that such communications remain clear, fair and not misleading from the viewpoint of these recipients. Software allowing the precise targeting of particular groups can be used to reduce the risk of a communication reaching unintended recipients.

Risk Warnings: Where a communication, such as a "tweet" or a "post", is accompanied by an image, care should be taken to ensure that any required risk warning is not solely contained in the image, as certain websites and applications grant the user an option to remove images from such communications.

Signposts: Communications containing a link to another website containing a financial promotion must be standalone compliant with FCA requirements.

Communicating Customer Feedback: A business forwarding or sharing (e.g. "retweeting") a customer communication, where the communication endorses a regulated financial product or service, will constitute a financial promotion by the business, even though the business did not produce the communication originally.

Cold Calling: The FCA advises that a person "following" or "liking" a business does not constitute "an established client relationship" or an "express request" for the purpose of the FCA's rules on unsolicited promotions.

Record Keeping and Approval: Businesses should keep adequate records of significant communications. In addition, businesses should have procedures in place so that only appropriately senior and competent employees are able to approve communications.

NEW SENIOR MANAGERS REGIME – PRA PUBLISHES FIRST SET OF FINAL RULES

On 23 March 2015, the Prudential Regulation Authority (**PRA**) published Policy Statement (PS3/15) which sets out its feedback to responses to the consultation papers on the new frameworks for individuals in the Banking and Insurance sectors (CP14/14, published July 2014[1] and CP26/14, published November 2014).

PS3/15 also sets out the first set of the PRA's final rules implementing the Senior Managers Regime (**SMR**) and Certification Regime for UK banks and PRA designated investment firms (**relevant authorised persons**) and the Senior Insurance Managers Regime (**SIMR**) for Solvency II insurers. The PRA noted that some elements of the new regimes need to be finalised in conjunction with the FCA and certain aspects of the regimes are still under development.

The PRA's final rules for relevant authorised persons cover: senior management functions (**SMFs**), allocation of Prescribed Responsibilities, the Certification Regime, and assessing fitness and propriety. The final rules set out in the PS3/15 come into force on 7 March 2016.

[1] Please refer to our Exchange International Newsletter, Issue 24 for further analysis of the PRA/FCA joint consultation paper.

1. Key matters still under development

The following elements are to be finalised:

- The treatment of non-executive directors (**NEDs**). In CP7/15, the regulators proposed that only the Chairman, Chairs of the Risk, Audit, Remuneration and Nomination Committees and Senior Independent Director would be subject to the SMR.
- The approach to the presumption of responsibility in section 66B, Financial Services and Markets Act 2000 (**FSMA**), which was also addressed in CP7/15. The PRA noted that a large number of respondents requested further clarification on how the regulators would apply the 'presumption of responsibility' in practice, in particular, the action required to satisfy the 'reasonable steps defence'.
- A template for the statement of responsibilities (CP28/14).
- The application of the new regimes to UK branches of foreign banks. In CP9/15, the PRA proposed to require all incoming non-EEA branches to have at least one individual pre-approved as a Head of Overseas Branch. If another individual based in another UK group entity has direct management and/or decision-making responsibility over the incoming non-EEA branch's UK-regulated activities, that individual needs to be pre-approved as Group Entity Senior Manager of the branch. Dedicated individuals performing certain executive SMFs will also need to be approved. The FCA proposed to apply a new SMF (*Overseas Branch Senior Manager*) to incoming non-EEA branches.

2. Final Rules

(a) Senior Management Functions

The PRA has not made any substantive changes to the set of SMFs proposed in CP14/14, but clarified the application of the Group Entity Senior Manager (SMF7) and the application of the SMR to small firms:

- The current approach to approval of senior individuals located overseas under the Approved Persons Regime (**APR**) will continue in relation to approval of the Group Entity Senior Manager Function (SMF7), i.e. there must be a direct link between the individual's decisions, powers and responsibilities and the areas and activities of the firm subject to UK regulation.
- The PRA will apply fewer requirements to firms with gross total assets of £250 million or less, calculated across a rolling period of five years or, if the firm has been in existence for less than five years, across the period during which it has existed. Such firms will only be required to have a CEO, CFO and a Chairman and be subject to a single, customised, shorter and simplified set of Prescribed PRA Responsibilities.

(b) Allocation of Prescribed Responsibilities

As proposed in CP14/14, it will be possible for Prescribed Responsibilities to be wholly allocated to more than one Senior Manager, but not split. This means that in principle, each individual could be deemed wholly responsible for the Prescribed Responsibility. In addition, the PRA will not allow firms to attempt to explain in the Statement of Responsibility which individual is responsible for which aspect of the Prescribed Responsibilities. However the PRA will allow individuals who have been allocated a Prescribed Responsibility "*to explain how the shared Prescribed Responsibility was discharged in practice when trying to demonstrate that he or she took reasonable steps to avoid the breach*".

The PRA has also:

- adopted the requirement for ring-fenced banks (**RFBs**) to allocate the RFB Prescribed Responsibility to all Senior Managers responsible for areas covered by the ring-fencing requirements;
- amended the wording of these two responsibilities to clarify that the CEO and Chairman should both play a leading role in their development and implementation;
- added Prescribed Responsibilities for large firms relating to stress testing (PR11) and remuneration (PR18); and
- clarified that the handover arrangements requirement does not entail a need for a handover certificate to be produced by the departing Senior Manager.

(c) The PRA's Certification Regime

The PRA will proceed with the approach to specifying certification functions set out in CP14/14. However, the PRA has decided to extend the 'grace period' proposed in CP14/14 from two weeks to four weeks.

(d) Assessing fitness and propriety

The PRA noted that respondents were generally content with its proposed approach to assessing the fitness and propriety of Senior Managers and with the factors firms should take into account. Therefore the PRA will proceed with these requirements, including the requirement to carry out criminal records checks before submission of a SMF application.

FCA PUBLISHES DISCUSSION PAPER ON MIFID II IMPLEMENTATION

On 26 March 2015, the FCA published a discussion paper (DP15/3) on its approach to implementing aspects of the MiFID II where it has discretion. The discussion is open for comments until 26 May 2015. Formal consultation on MiFID II implementation will take place later in 2015.

The discussion paper covers the following topics:

- **Applying MiFID II rules to insurance-based investment products and pensions**. Although not within MiFID scope, the FCA already applies most of its MiFID I-derived conduct of business rules (Conduct of Business sourcebook (**COBS**)) to such products. The FCA considers that insurance-based investments and pensions should, in principle, continue to be governed by the same conduct of business rules as MiFID II investments.
- **Treatment of structured deposits**. The investor protection requirements under MiFID II have been extended to cover structured deposits. These products are currently regulated through the Principles for Businesses and the FCA's Banking Conduct of Business sourcebook (**BCOBS**), which is less onerous than the requirements under the COBS and therefore the FCA is seeking views on how it should incorporate these new requirements.
- **Receipt of commissions and other benefits for discretionary investment managers**. MiFID II bans discretionary investment managers from accepting and retaining third party commissions, fees and monetary and non-monetary benefits, unless those payments are rebated in full to clients. The FCA is considering whether it should develop rules to ban receipt of such payments even if they are to be related to the client.
- **Professional client business – client categorisation and treatment of local public authorities and municipalities**. Local authorities are categorised as retail clients (with the ability to opt-up to elective professional status where they meet the qualifying criteria) under MiFID II. Member states have been given the discretion to adopt specific alternative or additional criteria for the assessment of the expertise and knowledge of such entities requesting the opt-up. The FCA has put forward three options on how they should exercise this discretion, but have stated that their initial preference is to strengthen the opt-up criteria.
- **Adviser independence**. MiFID II introduced a new EU-wide standard for 'independent advice', which requires firms offering independent advice to assess a "*sufficient range of different product providers' products...prior to making a personal recommendation*." The FCA's existing independence requirements cover "**retail investment products**", which includes some MiFID investment products (e.g. structured products and UCITS) and some non-MiFID products (e.g. insurance-based investments and personal pensions). However, the existing requirements do not cover other products such as shares, derivatives, bonds and structured deposits. The FCA does not consider it proportionate to include shares, bonds and derivatives in the retail investment products definition, but does consider it appropriate to include structured deposits within the definition of retail investment products (given its substitutability with other MiFID products).

- **Applying MiFID II's remuneration requirements for sales staff and advisers to non-MiFID firms**. The remuneration rules under MiFID II seek to ensure that sales staff and advisers are not incentivised to sell products inappropriately. There are currently various provisions that directly or indirectly seek to achieve the same outcome – Principle 3 which applies to all types of firms and Remuneration Codes in SYSC 19A (which applies to banks and CRD IV investment firms), SYSC 19B (which apply to alternative investment fund managers) and SYSC 19C (which applies to MiFID investment firms which do not fall within CRD IV). The FCA is seeking views on whether it should explore applying the remuneration standards under MIFID II to non-MIFID II business, e.g. applying the standards to consumer credit firms.
- **Recording of telephone conversations and electronic communications**. MiFID II requires member states to require 'Article 3 firms' (firms who are exempt from MiFID requirements pursuant to the optional exemption under Article 3 of MiFID) to comply with requirements 'analogous' to certain conduct of business and organisational requirements under MIFID II. Currently, such firms in the UK are subject to a domestic regime which satisfies the majority of the MIFID II requirements. However, the FCA Article 3 firms that are retail IFAs and boutique corporate broking firms do not need to comply with requirements relating to the recording of telephone conversations or electronic communications. The FCA is considering whether to apply MiFID II recording rules to all Article 3 firms. The FCA is keen to avoid inconsistencies in its supervisory approach and is therefore also proposing to remove the duplication exemption that currently applies to discretionary investment managers and MiFID II recording rules.
- **Costs and charges disclosure**. MiFID II introduces a new costs and charges disclosure requirement. The FCA is keen to explore the practical and technical challenges that firms may face in presenting aggregated costs and charges information to consumers. The FCA is also seeking views on whether it should investigate developing a standardised format for disclosing costs and charges for both point-of-sale and post-sale disclosures.
- **MiFID II's revised inducements standards**. MiFID II significantly strengthens existing MiFID I inducement standards and some MiFID II requirements are stricter than current UK rules. For example, MiFID II bans discretionary investment managers from accepting and retaining fees, commissions or any monetary or non-monetary benefits from third parties, (apart from certain minor non-monetary benefits). A number of changes will need to be made to current UK rules, e.g. the MiFID inducement rules apply to retail and professional client business, whereas the inducements rules under the UK Retail Distribution Regime (**RDR**) only applies to retail client business. The FCA also anticipates that UK rules for independent advisers will also need to be strengthened once the corresponding MiFID II rules have been finalised. The FCA is seeking views on whether it should maintain consistency and apply MiFID II's inducement standards for independent advice to restricted advice and to extend the requirements to insurance-based investments and pensions.
- **Complex and non-complex products and application of the appropriateness test**. MiFID II has restricted the types of products that can be classified as 'non-complex' which means that the types of products which can be sold execution-only have been narrowed. The FCA notes that the Commission is taking a strict interpretation of the new complexity criteria for debt securities and structured deposits and that it is likely that in future any shares and bonds that embed a derivative, structured UCITS, non-UCITS collective investment undertakings will be considered complex. The FCA view is that not all 'complex' products come with the same risks and therefore do not require the same level of knowledge and experience; however it would expect the appropriateness assessment to be particularly thorough where complex financial instruments are being offered to less experienced customers who may be less likely to understand the risks. The FCA also notes that firms which currently offer direct offer financial promotions are unlikely to be able to meet the requirements of the appropriateness test because the obligation to perform the appropriateness test is on the firm, not the client/ potential client.

FCA REGULATES SEVEN ADDITIONAL FINANCIAL BENCHMARKS

On 1 April 2015, the seven additional UK-based benchmarks set out below were brought within scope of the FCA's regulatory powers.

- Sterling Overnight Index Average (**SONIA**)
- Repurchase Overnight Index Average (**RONIA**)
- ICE Swap Rate (previously called ISDAFIX)
- WM/Reuters (WMR) London 4pm Closing Spot Rate
- LBMA Gold Price (which has replaced the London Gold Fixing)
- LBMA Silver Price
- ICE Brent Index

The London Interbank Offered Rate (**LIBOR**) has been within the perimeter of the FCA's regulatory powers since 2 April 2013. The extension of the scope of the regulatory regime for UK-based benchmarks follows recommendations arising out of the Fair and Effective Markets Review, which is led by the Bank of England, HM Treasury and the FCA and was launched in order to reinforce the integrity of and confidence in UK wholesale financial markets.

In respect of each of the benchmarks above, any person who collects, analyses or processes information for the purpose of determining a benchmark, or administers the arrangements for determining a benchmark (**Benchmark Administrator**), will be carrying on a regulated activity and will require FCA authorisation. Any person who provides information to another person in connection with and for the purpose of the determination of a relevant benchmark (**Benchmark Submitter**) will also need to be authorised by the FCA.

Chapter 8 of the Market Conduct Sourcebook (**MAR**) contains the relevant FCA rules with which Benchmark Administrators and Benchmark Submitters must comply. Chapter 8 of MAR has been amended to reflect the fact that, unlike LIBOR, a number of the additional seven benchmarks are determined based on publicly available data that has not been made available for the purpose of determining a benchmark, rather than based on information provided by Benchmark Submitters.

Chapter 8 MAR also contains new provisions requiring Benchmark Administrators to keep records on the information used to determine benchmarks and the originators of such information.

The changes to MAR came into effect on 1 April 2015 and are shown in the FCA's policy statement: *Bringing additional benchmarks into the regulatory and supervisory regime* (March 2015).

PRA SUPERVISION OF INTERNATIONAL BANKS: BRANCH RETURN REQUIREMENT

The PRA has published a policy statement: *Supervising international banks: the Branch Return*, in which the PRA confirms that it will be introducing a new rule requiring UK branches of banks incorporated outside of the UK (i.e. incorporated in either the EEA or a third country) to provide the PRA with a twice-yearly branch return, providing information on their UK activities. The PRA states that branch returns received as part of a voluntary pilot collection have supported the development of the PRA's risk appetite for branches, informed supervisory strategy for individual firms, provided a cross-firm view with regard to certain specific risks and supported policy formulation.

The new requirement to provide a branch return follows the recent implementation by the PRA of new rules requiring UK branches of non-UK banks to ensure that their resolution plans provide adequately for the resolution of UK branches. This requirement came into effect on 5 September 2014, following another PRA policy statement.

The new rules will come into effect on 1 July 2015.

BANK OF ENGLAND OUTLINES 2015 BANKING SYSTEM STRESS TEST

The Bank of England has published a paper: *Stress testing the UK banking system: key elements of the 2015 stress test* (**Paper**), which sets out the key elements of the 2015 stress testing of the UK banking system. The 2015 stress test will be carried out on banks and building societies that collectively account for around 70% of lending to UK businesses and 75% of UK mortgage lending.

In 2014, the Bank of England and PRA carried out the first concurrent stress test of the UK's largest banks and building societies, which followed on from the Financial Policy Committee's (**FPC**) March 2013 recommendation that the Bank of England and PRA should conduct regular stress testing on the UK banking system.

A key difference between the 2014 stress test and the 2015 stress test will be that the parameters and methodology of the 2015 stress test have been fully designed by Bank of England staff, whereas the 2014 was primarily a UK-adapted version of the EBA's EU-wide stress test of the European banking system.

There will be two core elements of the 2015 stress test, each of which is considered below.

Testing scenarios

Two scenarios will be considered as part of the stress test. First, a stress scenario will be considered, which is designed specifically to assess the resilience of UK banks and building societies to a deterioration in global economic conditions. Second, a baseline scenario will be considered, which will enable assessment of banks' and building societies' projected profitability and capital ratios in circumstances similar to those set out in the Bank of England's *Inflation Report* published in February 2015.

Hurdle rate framework

The results of the stress test will be used to inform the PRA's assessment of the capital adequacy of individual banks and building societies along with their risk management and capital planning processes. Where a bank's key capital ratios fall below certain thresholds in the stress scenario, it is likely that the PRA will require the bank to strengthen its capital position. The FPC will use the results to assess the UK banking system as a whole and develop system-wide policy responses where appropriate.

HM TREASURY LAUNCHES CONSULTATION ON MIFID II TRANSPOSITION

HM Treasury launched its Consultation on MiFID transposition on 27 March 2015. The government is seeking views on its draft secondary legislation as well as its general policy approach to certain policy areas where is has not provided draft legislation. However, on-going discussions between EU member states and the EU Commission on MiFID II transposition may result in amendment of the government's approach, particularly where areas of uncertainty are clarified (see below). The consultation closes on 18 June 2015.

Draft statutory instruments

The Treasury has published four draft statutory instruments as annexes to the Consultation:

- **Draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016** (Annex A of the Consultation). This draft instrument, amongst other things: provides for the exercise of the optional exemption under Article 3 of the MiFID II Directive; creates the position limit regime; and sets out obligations in relation to algorithmic trading, provision of direct electronic access services, acting as a general clearing member and the synchronisation of business clocks.
- **Draft Financial Services and Markets Act 2000 (Data Reporting Services) Regulations 2016** (Annex B of the Consultation). Persons who provide data reporting services (**DRS**) will need to be authorised under Article 59 of the MIFID II Directive. The government is proposing to create a specific regime for the DRSs which is independent of the Regulated Activities Order (**RAO**) and is seeking comments on its approach to the structure of the definition of Data Reporting Services Provider (**DRSP**). The government is also proposing to apply provisions akin to sections 89 (*Misleading statements*) and 90 (*Misleading impressions)* of the Financial Services Act 2012 to DRSPs.

- **Draft Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016** (Annex C of the Consultation). This draft instrument amends the RAO to: bring within its scope the new regulated activity of operating an organised trading facility; provide that structured deposits are within the scope of certain specified activities; make emission allowances a specified investment; make options and futures specified investments in certain circumstances involving alternative investment fund managers; and transpose the exemptions under Article 2 of the MIFID II Directive.
- **Draft Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016** (Annex D of the Consultation). This draft instrument amends the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013 to make MiFIR a qualifying EU provision for various parts of FSMA, which grants the FCA and PRA the appropriate powers to perform their roles arising from MiFIR.

The Treasury has also provided draft secondary legislation provisions which will provide that certain binary options are regulated and supervised by the FCA, rather than the Gambling Commission (Annex E of the Consultation).

Third Country Regime

There are two parts to the MiFID II third country regime:

- Article 47 of MiFIR allows third country firms to provide services to eligible counterparties and professional clients without the need to establish a branch provided that the firm is registered with ESMA.
- Article 39 of the MiFID II Directive gives member states the option to require third country firms who provide services to retail and elective professional clients to establish a branch in its jurisdiction. Branches authorised in accordance with Article 39 benefit from the MiFID passport.

Although the UK government acknowledges that the Article 39 MiFID II third country regime has a number of potential benefits (e.g. the MiFID passport), it is minded not to implement the regime. The government is proposing to retain its current third country regime, which broadly provides for three routes for accessing the UK market:

- establishment of a UK subsidiary that must apply for UK authorisation, which is then able to passport into other EU countries (sections 55A and 55B FSMA);
- establishment of a UK permanent place of business – a UK branch – and obtain authorisation for the third country entity. This is subject to prudential assessment and cooperation of the third country. The branch cannot then passport into other EU countries (section 55D FSMA); and
- reliance on exclusions provided for in UK legislation, e.g. the 'overseas persons' exclusion in Article 72 of the RAO, which includes exclusions for particular investment services and activities carried on in the context of a "legitimate approach" or carried on "with or through" an authorised or exempt UK person. In this case the entity will not have a physical presence in the UK.

Position limits and reporting

MiFID II introduces a position limit regime for commodity derivatives traded on trading venues and for economically equivalent OTC contracts. The regime applies to persons holding positions in relevant contracts whether or not the persons are authorised and therefore the government considers it preferable to implement the requirements as a "standalone" regime.

Structured deposits

Firms selling or advising clients in relation to structured deposits will need to comply with certain provisions under MiFID II (e.g. in relation to management oversight, organisational and conduct of business requirements and transactions executed with eligible counterparties). The government is proposing to amend Article 3 of the RAO to include the definition of structured deposit (to be copied out from MiFID II) and to extend the following regulated activities so as to apply to structured deposits: Article 21 (*Dealing in investments as agent*); Article 25 (*Arranging and making arrangements*); Article 37 (*Managing investments*); and Article 53 (*Advising on investments*).

Benchmarks

The government notes that once the proposed regulation on indices used as benchmarks in financial instruments and financial contracts (the **Benchmark Regulation**) has been settled, it will consider whether it needs to amend FSMA so that a "*person with a proprietary right to a benchmark*" (but who is not authorised) is subject to certain FCA enforcement powers and rights of information.

Power to remove board members

MiFID II introduces a new provision in Article 69(2)(u), which requires that a competent authority has at least the power to "*require the removal of a natural person from the management board of an investment firm or market operator*". The government is seeking views on the best approach to transpose this power and have outlined two options for consideration:

- Option A – rely on existing FSMA powers under the Approved Persons Regime; or
- Option B – create a new standalone power in Part V FSMA to allow the PRA/FCA to require an institution to remove members of its board where specific conditions are met.

Organised Trading Facility (OTF)

MiFID II creates a new category of investment service, the operation of an OTF, which will principally apply to firms carrying out matched principal trading electronically for clients. An OTF can only facilitate the trading of bonds, structured finance products, emission allowances or derivatives on a discretionary basis. The government proposes to amend the RAO to include this as a new regulated activity, but that it will not require firms to apply for a separate dealing in investments as principal permission, in addition to the activity of operating an OTF, if they engage in matched principal trading as an operator.

REPORTS

FCA PUBLISHES BUSINESS PLAN FOR 2015/2016

The FCA published its 2015/2016 business plan on 24 March 2015 (**Business Plan**), which sets out how the FCA plans to pursue its statutory objectives as well as its priorities for the 2015/2016 period. In previous years, the FCA had also published a risk outlook document alongside its business plan setting out the FCA's most important areas of focus for the relevant period. However, for the 2015/2016 period, the FCA has combined the business plan and risk outlook to form one document. The intention behind this change is to show clearly how the FCA's analysis of risk is connected to both its regulatory actions and how it seeks to advance its objectives.

FCA Priorities

A number of the FCA's priorities for the 2015/2016 period as set out in the Business Plan are set out below.

- **Review of retirement sales practices.** In light of the changes to the rules regarding access to pensions, the FCA will review retirement sales practices. In particular, the review will focus on how firms are supporting consumers to make appropriate choices on retirement given the wider range of options available.
- **Consumer credit regime.** The FCA will continue to implement and review the consumer credit regime, with a particular focus on youth indebtedness, which is becoming an increasingly significant feature of the market.
- **Developments in technology.** The FCA will monitor developments in technology and how such developments affect firms and consumers. In particular, the FCA will carry out a market study on the use of "big data" (such as web analytics and behavioural data tools) in the insurance market.
- **Mortgage market.** The FCA will assess the mortgage market and plan to examine how the market is operating following the Mortgage Market Review.

- **Wholesale markets.** Work in the wholesale markets will continue, including a market study into competition in investment and corporate banking services, as well as working alongside the Bank of England and HM Treasury on the UK Government's Fair and Effective Markets Review.

Risk Outlook

The Business Plan sets out the seven main areas of focus that the FCA considers pose the greatest risks to its objectives. These areas of focus are set out below. For the most part, they are consistent with the risk areas identified in the FCA's 2014/2015 risk outlook paper. However, in the Business Plan, the issue of rapid growth in house price has been replaced with financial crime as one of the FCA's top seven areas of concern. The FCA has stated that nevertheless rapid growth in house prices remains of significant concern.

- **Technological developments.** Increasing reliance on technological platforms and engagement with technologies could give rise to a number of risks, as utilisation of technology may outstrip firm and consumer capacity and capability, and may outperform the regulatory responses to the resulting risks.
- **Culture in firms.** The FCA considers that poor culture and controls threaten the soundness, stability and resilience of financial markets, although the FCA acknowledges that efforts have been made by firms to improve in these areas.
- **Large back-books of customers.** A large number of firms in certain retail markets operate with a large stock of back-books (stock of existing customers). Large back-books arise where customers remain with providers for many years. This often occurs in relation to current and savings accounts, insurance products and mortgages. There is a risk that firms may rely on extracting value from back-book customers to support profitability by cross-selling unwanted products and offering existing customers worse terms than new customers.
- **Old-age consumers.** Pensions, retirement income products and distribution methods may deliver poor consumer outcomes. A recent FCA market study into the retirement market demonstrated that consumers tend to under-estimate longevity, making it difficult for elderly consumers to determine the most appropriate products. The FCA considers that firms may develop decumulation products or services that highlight certain key features at the expense of other important information, as well as the products themselves being complex, opaque and overpriced.
- **Unaffordable debt due to poor practice.** Poor culture and practice in consumer credit affordability assessments could result in unaffordable debt. In particular, there is a risk that this will increasingly affect younger consumers. The FCA notes that increasing economic stress levels of consumers under the age of 30 may have resulted in an increased tendency for young people to use credit and debt products to service their day-to-day living. There is a risk that high levels of debt for younger consumers can lead to problems later in life, including problems in being offered a mortgage.
- **Unfair Contract Terms.** Consumers risk getting a bad deal if, based on unfair contract terms, firms change the nature or costs of their products, or have too much discretion as to what benefits derive from their products. This year, the scope for the assessment of fairness of consumer contract terms will be widened under the Consumer Rights Act. This follows recent cases from the European Courts, which have added clarity to the basis for assessing the fairness of consumer contracts.
- **Financial Crime.** Financial crime, in particular money laundering, as well as bribery and corruption, poses a risk to the integrity of the UK financial system. The FCA will continue to focus on these measures across the 2015/2016 period. The FCA indicates that it will work with the PRA, the Financial Stability Board and regulators internationally to address concerns about "derisking", whereby banks use issues around financial crime to move away from providing services to entire groups of customers or business sectors.

ENFORCEMENT

DEUTSCHE BANK FINED £226,800,000 FOR LIBOR BREACHES

Pursuant to a final notice dated 23 April 2015 (**Notice**), the FCA has fined Deutsche Bank AG (**Deutsche**) £226,800,000 in relation to Deutsche's manipulation of both the LIBOR and the Euro Interbank Offered Rate (**EURIBOR**) (collectively **IBOR**) rates over a period of at least five years.

In order to gain financial advantage, Deutsche, through its Money Markets Derivatives and Pool Trading desks, engaged in a course of conduct to manipulate Deutsche's IBOR submissions in breach of Principle 5 of the FCA's Principles for Businesses (**FCA Principles**) which requires firms to observe proper standards of market conduct. Deutsche's conduct also involved instances of collusion with external parties and the carrying out of certain trading activities in order to maximise impact on IBOR rates. Managers at Deutsche were central to this misconduct. The FCA held that there was a culture within Deutsche to increase revenues without proper regard to the wider integrity of the market.

In respect to manipulation of EURIBOR, traders influenced Deutsche's submitters to alter Deutsche's EURIBOR submission, contacted other banks and requested that they put in different EURIBOR submissions, and offered or bid cash in the market to create an impression of an increased or reduced supply in order to influence other banks to alter their EUIRBOR submissions.

The FCA also determined that Deutsche breached Principle 3 of the FCA Principles, which requires firms to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems. This breach arose out of Deutsche's failure to have any IBOR-specific systems and controls in place. Deutsche failed to address its lack of systems and controls even after being put on notice of the risk of misconduct. Furthermore, Deutsche had defective systems and controls in place to support the audit and investigation of traders more generally. Specifically, Deutsche had poor systems to facilitate the recovery of recordings of traders' telephone calls and the mapping of trading books to traders, which impeded the FCA's investigation.

Finally, Deutsche failed to comply with the Principle 11 requirement to deal with its regulators in an open and cooperative way, and to disclose to the appropriate regulator anything relating to the firm of which that regulator would reasonably expect notice. Deutsche's breaches of Principle 11 are set out below.

- First, Deutsche had recklessly failed to disclose a report relevant to Deutsche's misconduct which had been commissioned by the Federal Financial Supervisory Authority for Germany on the basis that Deutsche had been prohibited from disclosing the report by the German regulator. It transpired that no such prohibition existed.
- Second, an individual on behalf of Deutsche knowingly provided a false formal attestation to the FCA, which stated that Deutsche had adequate systems and controls in relation to LIBOR submissions at a time when no such systems or controls existed.
- Third, Deutsche failed throughout the FCA investigation to provide accurate, complete and timely information, explanations and documentation to the FCA, causing delay and difficulties to the FCA. The FCA concluded that such failures were not intentional on the part of Deutsche.

Overall, the FCA considered that the various breaches of Principles 3, 5 and 11 warranted significant financial penalties. In respect of Principles 3 and 5, the fundamental importance of the IBOR rates to the UK and global financial markets, as well as the exacerbation of the extent and duration of Deutsche's breaches caused its failure to have IBOR-specific systems and controls, were considered to be aggravating factors when determining Deutsche's financial penalty. Deutsche's breaches of Principle 11 were also considered to warrant a substantial financial penalty due to the involvement of Deutsche's senior management in Deutsche's breaches generally, along with a false formal attestation having been provided to the FCA.

As Deutsche agreed to settle at an early stage of the FCA's investigation, it qualified for a 30% reduction in the fine. Had the discount not been applied, the totally penalty would have been £324,000,000.

FCA BANS TRADER FOR LIBOR MANIPULATION

The FCA has issued a final notice dated 27 February 2015 (**Notice**), prohibiting Paul Robson, a former money markets trader, from performing any function in relation to any FCA-regulated activity following his involvement in the manipulation of the Japanese Yen LIBOR (**JPY LIBOR**) between at least May 2006 to at least early 2011. The Notice was issued after Robson, facing an indictment by the United States Department of Justice (**DoJ**), pleaded guilty to one count of conspiracy in relation to attempts to manipulate the JPY LIBOR. A copy of the indictment is attached to the Notice at Annex A.

Robson was employed by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (**Rabobank**) as a money markets trader between October 1990 and October 2008. As part of this role, Robson acted as the primary submitter for the JPY LIBOR for the bank. Robson submitted false statements to the British Bankers' Association and took requests from traders as well as trading positions into account when making such submissions in order to manipulate the JPY LIBOR to his advantage. Traders at Rabobank held positions in relation to derivative contracts which referenced the JPY LIBOR. Due to the scale of these positions, small moves in the JPY LIBOR could result in large swings in profit or loss for the bank.

In light of Robson's criminal conviction for an offence of dishonesty, the FCA determined that Robson lacks honesty and integrity and is hence not fit and proper. The seriousness of Robson's misconduct was aggravated by the fact that:

- he was an experienced employee of Rabobank and was an approved person;
- he engaged in the manipulation of the JPY LIBOR over a prolonged period of time; and
- LIBOR is of significant importance to the operation of UK and global financial markets.

The Notice follows a final notice dated 29 October 2013 issued by the FCA to Rabobank for manipulation of the JPY, USD and GBP LIBOR rates.

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US REGULATORS CLARIFY APPLICATION OF VOLCKER RULE'S "SOLELY OUTSIDE THE UNITED STATES" COVERED FUND EXEMPTION

The Volcker Rule prohibits US Banks, bank holding companies, and foreign banks with a US presence (**banking entities**) from having an ownership interest in, or sponsoring, certain covered funds. The prohibition does not apply, however, to a banking entity that acquires or retains an ownership interest in, or sponsors, a covered fund "solely outside of the United States" (the **SOTUS exemption**). The SOTUS exemption applies if:

- The banking entity is not organised or directly or indirectly controlled by a banking entity organised under US law (a **foreign banking entity**);
- The investment or sponsorship is made pursuant to Section 4(c)(9) of the Bank Holding Company Act (**BHC Act**);
- The investment or sponsorship occurs solely outside the US; and
- No ownership interest in the covered fund is offered for sale or sold to a US resident.

For purposes of the SOTUS exemption, an investment or sponsorship is made pursuant to Section 4(c)(9) of the BHC Act if the entity meets the requirements to be a qualifying foreign banking organization under the Federal Reserve's Regulation K. If the banking entity is not a foreign banking organization, it satisfies the requirement if it meets two of the following criteria: (a) total assets held outside the US exceed total assets held in the US; (b) total revenue from business outside the US exceeds total US revenue; or (c) total net income from business outside the US exceeds total net US income.

With regard to the third requirement, an investment or sponsorship occurs solely outside the US if (a) the banking entity – including its personnel – making the decision to invest in or sponsor the fund is not located in the US or organised under US law; (b) the investment or sponsorship is not accounted for as principal on a consolidated basis by a branch or affiliate located in the US or organised under US law; and (c) no financing for the investment is provided, directly or indirectly, by any branch or affiliate that is located in the US or organised under US law.

With regard to the fourth requirement, the regulations implementing the Volcker Rule clarify that an ownership interest is not offered for sale or sold to a US resident if it is sold pursuant to an offering that does not target US residents (the **"marketing restriction"**). What remained unclear under the implementing regulations, however, was whether the marketing restriction applied only to the marketing and sales activities of the foreign banking entity looking to take advantage of the SOTUS exemption or to all covered funds. The latter approach would mean that a covered fund offered and sold by an unrelated third-party would not be eligible for the SOTUS exemption if it had any US investors.

On February 27, 2015, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the **Agencies**) updated their Volcker Rule guidance to answer this question. The guidance clarifies that the Agencies interpret the marketing restriction to apply only when the covered fund is offered by the foreign banking entity seeking to take advantage of the SOTUS exemption, or its affiliates. The foreign banking entity may rely on the SOTUS exemption to invest in a covered fund, even without meeting the marketing restriction, so long as:

- neither the foreign banking entity nor its affiliates sponsor the covered fund or participate in the offer or sale of ownership interests, for example by acting as the fund's investment manager, investment adviser, commodity pool operator or commodity trading advisor; and
- the foreign banking entity otherwise meets the requirements of the SOTUS exemption.

Although it is somewhat inconsistent with the text of the rule, this interpretation allows a foreign banking entity to invest in covered funds alongside US investors, as long as it, or an affiliate, does not participate in the offer or sale of the covered fund.

In clarifying the marketing restriction, the Agencies referred to the preamble of the final regulations implementing the Volcker Rule, which states that the marketing restriction served to limit the SOTUS exemption so that it "does not advantage foreign banking

entities relative to US banking entities with respect to providing *their* covered fund services in the US by prohibiting the offer or sale of ownership interests in *related* covered funds to residents of the US." If the marketing restriction were applied to third-party activities, the Agencies explained, the SOTUS exemption may not be available, even though the risks and activities of a foreign banking entity's investment in a covered fund occurred solely outside the US.

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US AGENCY FOR CONSUMER FINANCIAL PROTECTION TO CONSIDER RULEMAKING TO LIMIT ARBITRATION IN CONSUMER FINANCIAL SERVICES CONTRACTS

The Consumer Financial Protection Bureau (the CFPB) 2015 Arbitration Study, released on March 10, 2015, lays the groundwork for rule-making to broadly restrict the use of arbitration provisions – including class-action waivers – in consumer financial services contracts.

The CFPB's Study arises under the Dodd-Frank Wall Street Reform and Consumer Protection Act's requirement that the CFPB prepare and submit to Congress a report on the use of pre-dispute arbitration clauses in consumer financial contracts. Three years in the making, this newly released Study foreshadows a seismic change for any company that operates a retail-banking unit or – more broadly – **any business that offers or provides to consumers a financial product or service through a contract that includes arbitration clauses**, including but not limited to agreements for credit cards, checking accounts or debit cards, auto loans, prepaid cards, payday loans and retail-installment contracts. In the credit card industry alone, the Study estimates that contracts containing such clauses could bind at least 80 million Americans.

The CFPB's broad authority under the Dodd-Frank Act to promulgate rules governing arbitration provisions and the express statutory requirement that any rules ought to comport with the findings of the CFPB's own Study – combined with the content of the Study itself – show that a rule making to prohibit or otherwise restrict the use of pre-dispute arbitration provisions is on the horizon. **Never before has a federal regulator proposed rules that would make it unlawful to force consumers to go to arbitration, and the Study signals that this may happen vigorously**. This represents a sea change in the ability of companies to resolve consumer disputes by arbitration.

While the immediate effect of this Study and the CFPB's follow-on rule making will impact banks and more traditional financial services companies, the ultimate effect may spill over into many other consumer contracts. **The Study and future rule making should be viewed as the beginning** of efforts to significantly restrict both the use of arbitration provisions and class-action waivers in most consumer contracts even when the affected business is not directly involved in the provision of financial products to consumers.

What is the purpose of the Study?

While arbitration clauses have long been used to resolve business-to-business contractual disputes, they began to appear frequently in consumer contracts only within the last two decades. Counsel in-house and at outside firms are well aware of the Federal Arbitration Act (FAA) and its gravitas as reiterated in the Supreme Court's 2011 landmark decision in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 179 (2011), holding that state laws deeming class-action waivers in arbitration agreements unenforceable under certain conditions are pre-empted by the FAA such that the state must enforce arbitration agreements. It is against this backdrop that the CFPB released the Study – the first ever of its kind – in conjunction with a field hearing and comments by Director Cordray regarding consumer arbitration provisions.

In announcing the Study, Director Cordray explained that, while the Study does not cover arbitration agreements in commercial settings, the Study finds them to be problematic in a consumer setting. The reasoning for this determination comports with the stance of the CFPB underlying all of its consumer education efforts to date and CFPB's enforcement actions, which have secured more than $5.3 billion in consumer relief since the CFPB's inception: where uneven bargaining powers may exist

between a consumer plaintiff and a corporate defendant in purchasing or using consumer financial services, **the goal of consumer protection includes an obligation to help level the playing field for consumers**. The Dodd-Frank Act authorises the CFPB to address this issue in the context of arbitration agreements. Section 1028 therein not only mandated the Study but also provided that the CFPB "by regulation, may prohibit or impose conditions or limitations on the use of" arbitration clauses in consumer financial contracts if the CFPB finds that a prohibition or limitation on their use "is in the public interest and for the protection of consumers" and the findings in such a rule are "consistent with the study" performed by the CFPB. Given the release of the Study, the CFPB is now well along in the process of addressing consumer arbitration provisions.

What did the Study conclude?

The findings of the Study are numerous, but it reached certain core conclusions that will form a basis for future efforts to restrict the use of arbitration and class-action waiver provisions in consumer arbitration agreements. Among these conclusions, the Study determined that:

- Consumer arbitration clauses are prevalent; credit card issuers representing more than half of all credit card debt have arbitration clauses in their consumer contracts
- Consumers are sometimes afforded an opportunity to opt out of arbitration clauses, but they generally are unaware of this option or do not exercise it
- Individual consumers are more likely to bring a lawsuit in court than to pursue a dispute in an arbitration proceeding, although arbitration proceedings conclude more rapidly than most court actions
- Although class action litigation resulted in changes to the consumer financial market that includes tangible (monetary relief) and intangible (changes in corporate behavior) benefits, the private sector may not be doing enough to stem potentially unfair practices, and further regulation is needed
- Arbitration clauses are effective for eliminating class actions; for instance, when credit card issuers with an arbitration clause were sued in a class action, the issuers invoked arbitration clauses to dismiss the class action nearly 66 percent of the time
- When comparing samples of consumer accounts for companies that dropped their arbitration clauses versus those for companies that continued to use arbitration clauses, no evidence existed of either (i) a price increase to consumers or (ii) a reduced access to credit for consumers when arbitration provisions were deleted, suggesting that arguments about the business costs of foreclosing arbitration are overstated
- Most consumers are unaware of or confused about arbitration provisions; among consumers who reported knowing what an arbitration provision was, 75 percent did not know that they were subject to an arbitration clause; also, of consumers who were subject to arbitration clause and reported knowing what a class action was, nearly 50 percent of such consumers believed that they could still participate in a class action, reflecting their lack of understanding of the effects of an arbitration agreement
- While assessing the overlap between private class actions and public enforcement actions in the context of consumer financial litigation, there was no overlapping private class action complaint in 88 percent of the enforcement actions; similarly, there was no overlapping public enforcement action case in related public enforcement actions 68 percent of the time, again underscoring that many aspects of consumer financial services disputes are not addressed by the private sector
- Where overlapping activity did exist, the Study found that public enforcement activity was preceded by private activity 71 percent of the time; by contrast, private class action complaints were preceded by public enforcement activity only 36 percent of the time.

The Study illuminates point-by-point each of the CFPB's justifications for a future rule making that would dramatically alter the landscape in the consumer financial services context through restricting mandatory consumer arbitration. Here are links to the report and fact sheet.

What can businesses expect from future rule making efforts by the CFPB?

- ***CFPB rule making to restrict arbitration in consumer financial services contracts:*** The CFPB will spare no expense or effort in future rule making to limit arbitration **and will do so aggressively**. In many ways, arbitration clauses strike at the heart of the reason why the CFPB exists. Given the consumer complaints reviewed in the Study, it is apparent that the CFPB seeks to respect dual objectives in carrying out its mission: a commitment to the market and to consumers. The Study seems to show that the CFPB believes that arbitration clauses for consumers are contracts of adhesion, involving no bargaining and an offering of provisions on a take-it-or-leave-it basis. Even if servicing errors, billing errors and other back-office functions cannot be made unlawful per se because consumers in the free market can choose the products they want, the arbitration provision is anathema to the CFPB. It is – based on the Study's research – not a result of free-market bargaining and wipes away whatever last-ditch solution customers might have to remedy mistreatment in the private market: the assumptions that individual actors have agency to act and may pursue self-help mechanism in the courts if the contract is not performed to satisfaction are evaporated with arbitration clauses.

  The CFPB likely will conclude that arbitration clauses (or at least "no-class arbitration" provisions) have a very limited place – or no place at all – in consumer financial services contracts. If this is the ultimate result of the CFBP's rule making efforts, almost all consumer financial services disputes will need to be resolved in court rather than by arbitration or arbitration tribunals will see greater attempts by consumers to proceed on a class basis.

- ***The CFPB may rely on unfairness to eliminate or restrict consumer arbitration provisions:*** The Study's findings foreshadow a possible intention of the CFPB to regulate consumer arbitration clauses through **the legal doctrine of unfairness**. The three elements under CFPB and Federal Trade Commission (FTC) jurisprudence to demonstrate an act or practice is unfair are that (i) the practice was likely to cause substantial harm to consumers; (ii) where such harm could not be reasonably avoided by consumers; and (iii) the practice had no countervailing benefit to consumers or competition. By reporting that arbitration clauses are in standard-form contracts and that consumers are unaware of their actual effect, the Study sets the stage for the CFPB to decide that consumers are unable to reasonably avoid the harm flowing from purportedly injurious provisions when they are unable to bargain them away or even intellectually appreciate their significance.

  Similarly, the Study's assertion that companies that dropped arbitration clauses offered products that did not increase financial harm to consumers or restrict consumers' access to credit is telling. This finding elucidates the CFPB's likely intent to lay groundwork in rule making for finding that the practice of inserting arbitration clauses in consumer contracts does not have a genuine countervailing benefit to consumers, meeting element (iii) of an unfairness claim. Accordingly, companies should expect to see early movements in the initial rulemaking process by the CFPB to entertain a potential rule that restricts or prohibits arbitration clauses through the Unfairness prohibition in Sections 1036(a) and 1031(a) of the Dodd-Frank Act.

- ***Private class actions are not sufficient to address the issue:*** Although the industry and commentators have opined on the harm that elimination of mandatory arbitration will cause through higher costs from frivolous class action litigation, in the calculus of the CFPB, it is not a zero-sum game. The externalities imposed by class action lawyers' conduct who may act based on financial incentives are considered to be unfortunate downfalls of the legal system for consumer financial protection, which the CFPB likely considers to be **vastly offset by the benefits achieved from class action litigation**. The CFPB has implicitly admitted in its Study that (1) enforcement programs, even its own, are no silver bullet for identifying and redressing harms that the CFPB believes are inflicted on consumers and (2) private class action litigation (versus a government enforcement action) is more likely to be filed first in these matters. Thus, despite the disproportionately high

incidence of private litigation that could arise solely from plaintiffs' attorneys' profit motivations, the CFPB may view a single class action success as important for consumers and society. For these reasons, the legitimate arguments regarding the flaws of the class action system are likely to fall on deaf ears at the CFPB.

- ***More litigation is to be expected:*** If arbitration clauses are prohibited or restricted by the CFPB, businesses will see a marked **increase in the amount of litigation** asserted by consumers **under many consumer financial protection laws**, including the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Fair Debt Collection Practice Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, the Homeowner Protection Act of 1998, the Real Estate Settlement Procedures Act, the Truth in Savings Act, the Truth in Lending Act, the Credit Repair Organization Act, and the Telephone Consumer Protection Act, among others.

Conclusion

While the Study reports a wealth of empirical information, ultimately it will be used to justify the CFPB's future conduct in upcoming rulemaking that is likely to greatly limit or eliminate arbitration provisions or class-action waivers in consumer financial services contracts. Resulting restrictions in the availability of consumer arbitration provisions will spill over into other consumer contracts. Businesses can mitigate these coming risks by using the time before the rule making to make thoughtful comments to the CFPB and to assess their dispute-resolution provisions and their business practices and procedures.

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COMMERZBANK FINED $1.45 BILLION FOR AML AND SANCTIONS FAILINGS

Commerzbank AG (**Commerzbank**) has agreed to pay various United States authorities US$1.45 billion and to take a number of remedial actions, including the dismissal of four employees, after a large number of sanctions and AML regulation violations. A summary of Commerzbank's breaches and the penalties imposed on Commerzbank is set out below. The facts are set out in more detail in a consent order dated 12 March 2015 entered into between The New York State Department of Financial Services (**Department**) and Commerzbank.

Structural and Procedural Deficiencies in Commerzbank's AML Compliance Programme

Commerzbank's New York Branch (**New York Branch**) maintained correspondent accounts for Commerzbank's foreign branches. However the New York Branch did not have access to due diligence information about customers of these foreign branches and hence could not conduct AML monitoring.

Foreign branches often transmitted payments to the New York Branch using non-transparent SWIFT payment messages that did not disclose the identity of the remitter or beneficiary. As a result of not having access to all of the relevant information about transactions, the New York Branch's compliance procedures were ineffective and fewer alerts or red flags were raised than would have been if all of the relevant information had been shared.

Even when alerts or red flags were raised in respect of transactions from foreign branches, the New York Branch compliance staff did not have direct access to the customer information necessary to investigate the alerts or red flags and had to request such information directly from the relevant foreign branch or Commerzbank's Frankfurt office. Responses to such requests often took many months or were inadequate, which prevented the New York Branch from investigating alerts properly and led to alert backlogs. On a number of occasions after information had not been provided from foreign offices, New York Branch employees carried out their own inadequate searches of the internet and public databases and subsequently closed off alerts. There were instances where compliance staff in the New York Branch attempted to strengthen transaction monitoring filters by adding the names of certain high-risk clients to the filters, but were prevented from doing so by staff at the Frankfurt office.

Alteration of Transaction Monitoring System to Reduce Number of Alerts

Until 2010, the thresholds of the transaction monitoring system were set based on a desire not to produce too many alerts. In 2011 a compliance staff member was asked by two senior compliance employees to reduce the thresholds in order to reduce the number of alerts generated.

Facilitation of Fraud by the Olympus Corporation

Between the late 1990s and around 2011, the Olympus Corporation (**Olympus**) perpetually committed account fraud in order to conceal hundreds of millions of dollars in losses from its auditors and investors. This fraud was carried out through several Commerzbank group companies and branches including the New York Branch. The New York Branch facilitated transactions totalling more than US$1.6 billion that supported or were related to Olympus' fraud, most of which did not trigger alerts in the New York Branch's transaction monitoring system. However, two large transactions in 2010 did raise alerts in the New York Branch. When responding to a request by the New York Branch for information on these transactions, personnel in the Singapore office did not relay any concerns about Olympus. This was despite personnel employed by the Singapore office having identified the same two transactions as suspicious and having broader concerns about Olympus in respect of its structure and transactions.

PAYMENT SERVICES DIRECTIVE II – PROPOSED PROVISIONS

The proposed second payment services directive (**PSD II**), set to be passed in the coming months, will repeal and replace the existing payment services directive (Directive 2007/64/EC) (**PSD I**). The European Commission published its proposal for PSD II in July 2013. Various redrafts of PSD II have been produced by the Presidency of the Council of the EU. The most recent draft publically available was published by the Council on 2 December 2014. Trilogue discussions on a compromise text commenced in February 2015 and agreement is expected by the end of June 2015 (i.e. by the end of the Latvian Presidency of the Council).

The proposed core changes to the existing payment services regime, as per the 2 December 2014 draft, are set out below.

Widened Scope of the Payment Services Regime

The scope of the transparency and information requirements and the conduct of business provisions of the regime will for the most part be extended to apply (i) to payment transactions where just one (rather than both) of the payment service providers (**PSPs**) is located within the EU and (ii) to payment transactions in all currencies that are not currencies of any EU Member State, where both the payer and payee's PSPs are located within the EU. This constitutes a significant widening of the current scope of the payment services regime.

Additional Payment Services

Payment services regulated by the regime will be widened to include payment initiation services (**PISs**) and account information services (**AISs**).

A PIS is a service whereby a payment initiation service provider (**PISP**) provides a software bridge between the website of a merchant and the online banking platform of a payer's bank. This allows a payer to initiate an online banking transfer from the payer's bank account to the merchant through the software, which provides immediate confirmation to the merchant that the requisite funds are available and the transfer has been initiated by the payer. This encourages the merchant to release goods or services immediately, sure in the knowledge that it will receive payment. PISs allow payments to be confirmed instantly without the use of a credit or debit card. A PISP does not hold the payer's funds at any point in time. PISPs will have to obtain full authorisation from the relevant competent authority under PSD II, regardless of the size of their operations.

An AIS is an online service that provides consolidated information on one or more of a user's online payment accounts, which may be held with numerous account providers. An account information service provider (**AISP**) retrieves information from the online banking platform of each of the user's banks, in order to bring together such information on the AISP's website or application. AISPs will be required to register with the relevant competent authority but will not have to obtain full authorisation.

Member States will have to ensure that payers have a right to use both PISs and AISPs. Bank account providers will be obliged to facilitate the use of these new payment services and will not be able to discriminate in respect of payment orders received through a PIS or data requests made by an AISP.

PSD II Exemptions

A number of changes have been made to the PSD I exemptions for services that do not trigger the need for the relevant PSPs to be authorised or registered. The "commercial agents" exemption will be redrafted to close a loophole used by e-commerce platforms to carry out payment services when acting as an intermediary between a buyer and seller in online transactions. The exemption for use of instruments in limited networks (e.g. store cards) will be further restricted. Independent ATM providers will still be exempt under PSD II but will be made subject to certain transaction information requirements. Two new exemptions will be introduced to allow charitable donations and ticket purchases to be made through devices such as mobile phones.

Charges for Use of a Payment Instrument

In transactions where a payer wishes to use a particular payment instrument, the payee may wish to add a surcharge to a transaction to cover its costs in accepting payment by such a method. The legality of these surcharges varies between Member States. PSD II will harmonise the position by prescribing that a payee generally cannot be restricted from requesting a surcharge, as long as the surcharge is capped at the payee's actual costs in accepting payment by the particular method.

However, there is a significant exemption to this general rule in PSD II, which will prohibit surcharging in respect of transactions for which interchange fees will be regulated under the upcoming regulation on multilateral interchange fees (MIFs) (**MIF Regulation**), which was adopted by the European Parliament on 10 March 2015 and will come into force on the 20th day following its publication in the Official Journal of the EU. The MIF Regulation will cap interchange fees between banks in relation to most credit and debit card transactions in the EU (the most notable exception being certain three-party payment scheme transactions). As such, payees will not be able to request a surcharge for these debit and credit card payment transactions once PSD II is implemented.

Unauthorised Payment Transactions – Reduced Payer's Liability

The maximum charge that a payment user can be obliged to pay in respect of an unauthorised payment transaction (except for in the case of fraud or gross negligence) will be reduced from EUR 150 to EUR 50.

Security and Incident Reporting

PSD II will require PSPs to establish a framework to manage operational and security risks in relation to their services, which must incorporate mitigation measures and control mechanisms. PSPs will have to report annually to the relevant competent authority on these risks and risk mitigation procedures.

On the occurrence of a major operational or security incident, a PSP will be required to inform the relevant competent authority and any payment service user whose financial interests are affected by the incident.

In respect of payments initiated over the internet, PSPs will be under an obligation to apply strong customer authentication checks in order to mitigate the risks of payment fraud.

Internal Dispute Resolution

PSPs will be obliged to put in place adequate and effective internal consumer complaint resolution procedures and will be subject to maximum response times in respect of consumer complaints.

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FINANCIAL SERVICES TEAM

DLA Piper's dedicated Financial Services team offers specialist legal expertise and practical advice on a wide range of contentious and advisory issues. The team can assist clients on contentious legal matters including: internal and regulatory investigations, enforcement actions and court proceedings in the financial services sector. There is also an experienced advisory practice which gives practical advice on all aspects of financial regulation, including the need for authorisation, regulatory capital, preparation for supervision and thematic visits, conduct of business issues and financial promotions.

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