FINANCIAL SERVICES REGULATION
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DLA PIPER

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INTRODUCTION

WELCOME

DLA Piper's Financial Services International Regulatory team welcomes you to the twenty-eighth 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 the UK, the USA and Singapore.

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 latest developments in the EU's plans for a Capital Markets Union.

In addition, we look at the Payment Systems Regulator's application of European interchange fee rules; proposed changes by the FCA to its Compensation sourcebook; new UK secondary legislation to make it easier for small and medium-sized enterprises to access alternative sources of finance; FCA consultations on cloud-based outsourcing, payment protection insurance complaints, and the implementation of the Market Abuse Regulation; FCA final rules on the Approved Persons regime for insurers not subject to the Solvency II Directive; the Government's proposed extension of the Senior Managers Regime; new rules on whistleblowing; and FCA and PRA enforcement across the areas of approved persons and outsourcing; as well as a regulatory update from the European Union, the USA and elsewhere internationally.

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.

EUROPEAN UNION

EUROPEAN RULES ON CENTRAL CLEARING FOR INTEREST RATE DERIVATIVES BECOME LAW

In the last issue of Exchange – International, we reported that the European Commission had adopted rules on central clearing for interest rate derivatives. These rules prescribe the mandatory clearing of certain over-the-counter **(OTC)** interest rate derivative contracts through central counterparties **(CCPs)** pursuant to the European Markets Infrastructure Regulation (EU) 648/2012 **(EMIR)**.

Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 **(Delegated Regulation)**, which prescribes these rules, has now been published in the Official Journal of the EU, making it legally binding. This comes following passage of the Delegated Regulation through the co-legislative procedure in the European Parliament and the Council.

Classes of OTC derivatives subject to EMIR Clearing Obligations

The Delegated Regulation provides that certain classes of OTC interest rate swap derivative contracts (**IRSs**) are to be subject to the EMIR clearing obligation. As reported in the last issue of Exchange – International, IRSs denominated in euro, pound sterling, Japanese yen or US dollars are covered. The contracts to which the rules relate are fixed-to-float IRS (**IRS or 'plain vanilla' derivatives**), float-to-float swaps (**basis swaps**), forward rate agreements and overnight index swaps.

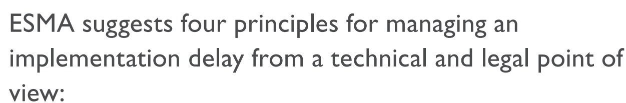
The date on which the clearing obligation takes effect in respect of an IRS depends on the categorisation of the counterparties to the contract. The counterparty categories and their corresponding clearing obligation dates are as follows:

- **Category 1** – comprises counterparties which, for at least one of the classes of IRS, are, on 21 December 2015, clearing members of a CCP authorised or recognised before 21 December 2015 to clear at least one of those classes of IRS. The clearing obligation shall take effect for counterparties in Category 1 on 21 June 2016.
- **Category 2** – comprises counterparties which do not belong to Category 1; belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for January, February and March 2016 is above €8 billion; and are either financial counterparties (**FCs**) as defined by Article 2(8) of EMIR, or non-financial counterparties (**NFCs**) that are alternative investment funds (**AIFs**) as defined in the Alternative Investment Fund Managers Directive (2011/61/EU). The clearing obligation date for Category 2 counterparties is 21 December 2016.
- **Category 3** – comprises counterparties which do not belong to Category 1 or Category 2; and are either FCs, or AIFs that are also NFCs. Category 3 'sweeps up' the remaining FCs and AIFs that are also NFCs which do not have large enough portfolios of derivatives to fall within Category 2. The obligation shall come into effect for Category 3 counterparties on 21 June 2017.
- **Category 4** – comprises NFCs that do not fall within Categories 1-3 above. The Clearing Obligation Date for Category 4 counterparties will be 21 December 2018.

MIFID IMPLEMENTATION DELAYS

On 18 November 2015, the European Securities and Markets Authority (**ESMA**) published a note on the delay of the implementation of the amended Markets in Financial Instruments Directive (**MiFID II**). In the note, ESMA identifies possible delays in the expected real applicability of certain MiFID II provisions, particularly those related to the development of IT systems by regulators and market participants that need to interact with one another. Specifically, ESMA notes acute concerns about the start date for IT systems which are required to record and interact on market reference data, transaction reporting, transparency parameters and publication and position reporting.

According to the note, allowing for the shortest possible delay in the next stages of the co-legislative procedure, the current calendar leaves less than nine months (March 2016-January 2017) for the development, programming, testing and deployment of the systems needed for MiFID II implementation. In relation to the most complex systems, ESMA classes this nine-month timeframe as "way too short".



ESMA suggests four principles for managing an implementation delay from a technical and legal point of view:

- give legal certainty, as early as possible, to the entities subject to MiFID;
- minimise the delay as from the original start date;
- avoid re-adjustments to the date (move it only once); and
- define dates that maximise the possibility of simultaneous launch for all the markets/Member States.

ESMA proposes three courses of action in tackling the forecasted implementation delays and strongly favours a Level 1 fix.

- A Level 1 fix: postponing for a few months the application date of some articles.
- A Level 2 fix: fixing the applicability date at a later time than the applicability date of Level 1.
- A Level 3 fix: agreeing between all national competent authorities, and publishing at ESMA level, an implementation date that would be later than the one contained in the Level 2 provisions.

On 27 November 2015, the European Parliament published a press release stating its position on a potential delay of the entry into force of MiFID II. In the press release, the European Parliament announced that it is willing to accept a one year delay of the entry into force of MiFID II, provided that the Commission takes into account the Parliament's priorities, including the swift finalisation of the implementing legislation. The Parliament also stressed the need for the Commission and ESMA to come up with a clear roadmap on the implementation work and especially for setting up the IT-systems. The Parliament's position was set out in a letter to the Commission from the Chairman of the Parliament's Economic and Monetary Affairs Committee and the Parliament's Rapporteur for MiFID II. The letter further requests regular reports to be made back to the Parliament on the progress towards implementation, including timelines and key milestones.

EUROPEAN COMMISSION SUES SIX COUNTRIES FOR NOT ADOPTING BRRD

The European Commission announced on 22 October 2015 that it is referring the Czech Republic, Luxembourg, the Netherlands, Poland, Romania and Sweden to the European Court of Justice (**ECJ**) for failing to transpose the Bank Recovery and Resolution Directive (*2014/59/EU*) (**BRRD**) into domestic law.

Background to the BRRD

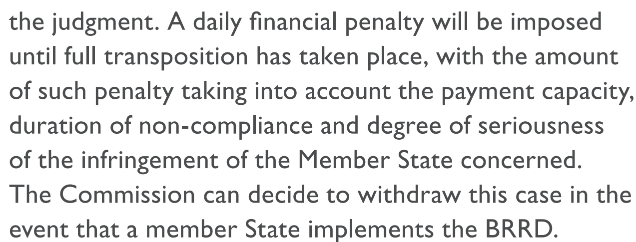
The BRRD was adopted on 15 April 2014 and published in the Official Journal of the EU on 12 June 2014. It equips national authorities with powers with the aim of avoiding bank failures and, in the event of a failure, minimising the risk of disruption to essential services, damage to the financial system and the need for taxpayer bailouts. The objective of the BRRD is to ensure banks on the verge of insolvency can be restructured without taxpayers support. Accordingly the BRRD imposes a 'bail-in' mechanism to ensure that shareholders and creditors of the banks bear the main costs of resolution.

The BRRD introduces a requirement on banks to prepare recovery plans and authorities to prepare resolution plans based on information provided by banks. The BRRD also gives early action powers to authorities such as the ability to require a bank to implement its recovery plan and the ability to replace existing management with a special manager. Authorities are also given the means to ensure the continuity of essential services in the event of a resolution and to manage the failure of a bank in an orderly way. These include a sale of business tool, a bridge institution tool, an asset separation tool and a debt write down (bail-in) tool. The BRRD further introduces mechanisms for cross-border crisis management – allowing co-operation between resolution authorities – and resolution funds that can be drawn on to cover costs of using resolution powers and tools.

Member States' failures in implementation

The deadline for transposing the BRRD rules into national law was 31 December 2014. The Commission, on 28 May 2015, asked the 11 EU Member States who had at that point failed to implement the rules to do so. By 22 October 2015, full transposition had not taken place in the Czech Republic, Luxembourg, the Netherlands, Poland, Romania and Sweden, and as a result the Commission decided to refer these Members States to the ECJ.

The EU's infringement procedure stipulates that if the ECJ rules against a Member State, the Member State must then take the necessary measures to comply with



the judgment. A daily financial penalty will be imposed until full transposition has taken place, with the amount of such penalty taking into account the payment capacity, duration of non-compliance and degree of seriousness of the infringement of the Member State concerned. The Commission can decide to withdraw this case in the event that a member State implements the BRRD.

SECURITIES FINANCING TRANSACTIONS REGULATION ENTERED INTO THE OFFICIAL JOURNAL OF THE EU

On 23 December 2015, *Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) 648/2012* (**Regulation**) was published in the Official Journal of the EU. The Council of the EU stated in a press release that the aim of the Regulation is to counter the risk of trading activities developing outside the regulated banking system, or within what is known as the "shadow banking" system. The Financial Stability Board defines the shadow banking system as "the system of credit intermediation that involves entities and activities outside the regular banking system". Some of the risks of shadow banking that have been identified include the existence of deposit-like funding structures that may lead to runs, a build-up of high, hidden leverage, the circumvention of rules and regulatory arbitrage, and disorderly failures that can affect the banking sector. The Regulation also contains requirements in relation to the reuse of financial instruments.

This article aims to outline the requirements introduced by the Regulation and the dates by which those requirements are to take effect.

Key requirements imposed by the Regulation

The Regulation requires counterparties to a securities financing transaction (**SFT**) to (i) report the SFT's details to a trade repository upon its conclusion, modification and termination; and (ii) keep records of the SFT for at least five years following its termination.

Furthermore, a party reusing financial instruments received under a collateral arrangement is required to (i) first disclose the risks and consequences and obtain written consent, and (ii) only exercise its right to reuse in accordance with the collateral arrangement's terms and only with respect to financial instruments that have been transferred from the providing counterparty's account.

The Regulation also requires managers of undertakings for collective investment in transferable securities (**UCITS**) and alternative investment fund managers (**AIFMs**) to disclose their use of SFTs and total return swaps to investors in their half-yearly and annual reports and in their pre-investment disclosures.

For the purpose of reporting and reuse requirements, the Regulation applies to an EU entity's non-EU branch that is party to an SFT or engaging in reuse, and a non-EU entity that is party to an SFT or engaging in reuse (subject to certain conditions being met).

SFT reporting requirements

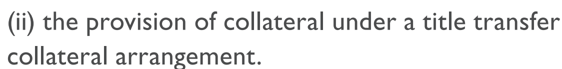
Although both counterparties to an SFT have an obligation to do so, a financial counterparty is responsible for reporting the details on behalf of both counterparties where its counterparty is a non-financial counterparty which on its balance sheet date does not exceed at least two of the thresholds of: (i) a €20 million balance sheet total; (ii) a €40 million net turnover; and (iii) 250 employees on average during the financial year.

Where a UCITS or an alternative investment fund (**AIF**) is the counterparty to an SFT, the UCITS manager or AIFM shall be responsible. Furthermore, the reporting obligation may be delegated.

The minimum information to be reported includes the parties, the principal amount, the currency, the assets used as collateral, and whether the collateral is available for reuse.

Reuse requirements

A counterparty shall only be allowed to reuse financial instruments received under a title transfer or security collateral arrangement if it first discloses to the providing party the risks and consequences of either (i) granting a right of use of collateral provided under a security collateral arrangement; or (ii) concluding a title transfer collateral arrangement. A further condition to the ability to reuse is the requirement to obtain the providing party's express written consent to (i) a security collateral arrangement that includes a right of reuse; or



(ii) the provision of collateral under a title transfer collateral arrangement.

The reuse undertaken must also be in accordance with the original security collateral arrangement or title transfer collateral arrangement and the financial instruments received under the arrangement must first be transferred from the account of the providing counterparty.

UCITS and AIF disclosure requirements

UCITS management companies, UCITS investment companies and AIFMs must disclose certain specified information to investors about their use of SFTs and total return swaps. This must be done by UCITS management and investment companies in their half-yearly and annual reports, and by AIFMs in their annual report. The minimum information to be disclosed includes the amount of securities and commodities on loan as a proportion of total lendable assets and the amount of assets engaged in each type of SFT and total return swap expressed as an absolute amount and as a percentage of the fund's total assets under management.

As part of pre-contractual disclosure, UCITS management or investment companies and AIFMs are also subject to a requirement to specify which SFTs and total return swaps they are authorised to use and include a clear statement that those transactions are used.

Consequences of non-compliance

Competent authorities must be granted the power to impose sanctions for breaches of the SFT reporting and reuse requirements. However, a breach of the SFT reporting requirement will not affect the validity or enforceability of the SFT itself.

Implementation timetable

The Regulation, including the requirement to keep records of any SFTs for at least five years following the transaction's termination, will enter into force 20 days after its publication in the Official Journal. However, certain requirements are to take effect from a later date. The reuse requirements will enter into force six months after the Regulation's entry into force. These reuse requirements will apply to collateral arrangements existing on that date.

The UCITS and AIFMs' use of SFTs and total return swaps reporting and pre-contractual disclosure requirements will enter into force 12 and 18 months after the Regulation's entry into force, respectively. The 18 month pre-contractual disclosure requirement applies only to AIFs and UCITs that are already constituted before the Regulation's entry into force.

Subject to conditions on the SFTs' maturity, reporting requirements will enter into force six months after the Regulation's entry into force in relation to investment firms and credit institutions. The effective date is 15 months for central securities depositories and central counterparties, 18 months for insurance/reinsurance undertakings, UCITS/UCITS managers, AIFs/AIFMs and institutions for occupational retirement provision, and 21 months for non-financial counterparties.

UNITED KINGDOM

UK REGULATORY DEVELOPMENTS

PSR SETS OUT INTERCHANGE FEE RULES

On 2 December 2015, the Payment Services Regulator (**PSR**) published a consultation paper *(CP15/3: the application of the Interchange Fee Regulation in the UK: Phase 1)* and draft guidance in relation to its role as the UK competent authority for the EU Regulation on interchange fees for card-based payment transactions (**IFR**), which was adopted on 29 April 2015. HM Treasury implemented the IFR regulation in the UK through the Payment Card Interchange Fee Regulations 2015 (**PCIFR**), which came into force on 9 December 2015. On 20 November 2015, the PSR published a request for information from stakeholders in order to determine whether any schemes qualify for a temporary exemption from part of the IFR.

The IFR applies to card-based payment transactions carried out within the EU, where both the payer and the payee's payment systems providers are located within the EU. An interchange fee is defined in article 2(10) of IFR as a fee paid for each transaction directly or indirectly (i.e. through a third party) between the issuer and the acquirer involved in a card-based payment transaction. The issuer is the payment services provider (**PSP**) that provides the payer with the payment instrument (i.e. credit/debit) to initiate and process the payer's card-based transactions, whereas the acquirer is the PSP that accepts and processes card-based transactions on behalf of the payee, which results in a transfer of funds to the payee. In practice, the acquirer deducts a fee from the transaction amount for processing the payment before paying the funds on to the payee. A percentage of this deducted amount (typically 70%) is the multilateral interchange fee (**MIF**), which is passed to the issuer. One of the primary functions of IFR is to cap the MIFs.

Although the IFR has direct effect, it contains certain Member State discretions as well as obligations.

The discretions provided in the IFR cover three areas, namely:

- the option to implement lower interchange fee caps for domestic credit card transactions than those set out in the IFR;
- the same option in relation to domestic debit card transactions. There are further Member State discretions in relation to how interchange fee caps for domestic debit card transactions are applied, include the option to apply the cap on a weighted average basis for a period of up to five years; and
- the option to exempt three party card schemes that use issuers or acquirers from caps to interchange fees for a period of up to three years, provided that the scheme's market share remains below 3% in that Member State.

The IFR requires Member States to designate competent authorities, lay down rules on penalties and take measures for the settlement of disputes. As well as designating the PSR as competent authority in the UK for the IFR, the PCIFR designates the FCA as competent authority in the UK in relation to articles 8 (co-badging and choice of payment brand or payment application) (2), (5) and (6), 9 (unblending), 10 ('Honour All Cards' rule) (1) and (5), 11 (Steering rules) and 12 (information to the payee on individual card-based payment transactions) of the IFR.

The PCIFR set fee caps for the UK for credit and debit card transactions. This cap is 0.3% for credit card transactions and 0.2% for debit card transactions. The UK has exercised the option to allow card schemes and banks to apply the fee cap for debit card transactions on the basis of a weighted average until 9 December 2020. Therefore the cap would be 0.2% of the annual average value of all UK debit card transactions within the scheme.

The UK government has also availed of the option to grant a time-limited exemption from domestic interchange fee caps to three-party schemes which operate with licensee issuers or acquirers, or issue cards with a co-branding partner or through an agent. To qualify for the exemption, the value of a scheme's annual UK domestic transactions must be less than 3% of all card-based transactions in the UK. The transactions are in the UK if the issuer, acquirer and merchant are all located in the UK.

The PSR expects that the IFR will bring major changes to UK card payment systems. Hannah Nixon, Managing Director of the PSR, said: "The intention of the IFR, as well as providing savings to consumers by reducing fees, is to boost transparency and remove barriers so others can enter the market and compete. These are goals that tally closely with those of the PSR and our wider agenda for UK payment systems."

FCA PROPOSES CHANGES TO COMPENSATION RULES

On 30 November 2015, the FCA published a consultation paper (*CP15/40: Financial Services Compensation Scheme: changes to the Compensation sourcebook*) proposing changes to the Compensation Sourcebook (**COMP**), which governs the operation of the Financial Services Compensation Scheme (**FSCS**).

The proposals include an increase in the non-investment (general and pure protection) insurance mediation compensation limit from 90% to 100% in relation to some types of insurance relating to pure protection contracts, professional indemnity insurance and general insurance arising from the death or incapacity of the policyholder owing to injury, sickness or infirmity. The increase of the protection limit is analogous to the protection offered by the PRA rules when a provider fails. Under the current rules, consumers are entitled to different levels of compensation for similar types of claim depending on whether the insurance provider or intermediary fails. The FCA's proposed changes remove that discrepancy, in order to ensure that consumers will receive the same protection from the FSCS whether the insurer or intermediary fails.

The consultation paper also proposes changes to the eligibility of occupational pension schemes trustees to claim through the FSCS. Trustees of occupational pension schemes of large employers providing money purchase benefits would be eligible to claim. However, trustees of small self-administered schemes of large employers providing defined benefits would no longer be eligible.

Changes are also proposed to make express reference in COMP to how the compensation rules apply where a successor firm is in default. Under current rules, when claims arise against a successor firm that is authorised, in respect of liabilities arising from the acts or omissions of a predecessor firm, these claims will fall within the scope of the FSCS. This is achieved by the successor entering into a deed providing for joint and several liability with the predecessor, or other means of the successor accepting responsibility. Changes to the Financial Services and Markets Act 2000 which came into effect on 1 April 2013 require the FCA to make rules in relation to FSCS protection in such cases where liability has been assumed by successor firms who are unable, or likely to be unable, to satisfy claims against them. The changes therefore clarify the current rules and also propose extending them to unauthorised successor firms.

CP15/40 also proposes introducing increased flexibility in relation to the recipient of compensation, so that not only the claimant, but also a third person directed by the claimant, can receive compensation.

Finally, a rule is being proposed expressly requiring firms to cooperate with the FSCS in order to assist it in carrying out its statutory functions.

The deadline for responses is 29 February 2016 and the FCA intends to publish its rules in a policy statement in the second quarter of 2016.

SME CREDIT INFORMATION AND FINANCE PLATFORMS REGULATIONS 2015 PUBLISHED

HM Treasury has published two new statutory instruments in relation to the business financing of small and medium sized enterprises (**SME**): *the Small and Medium Sized Business (Credit Information) Regulations 2015 (SI 2015/1945)* (**Credit Information Regulations**); and *the Small and Medium Sized Business (Finance Platforms) Regulations 2015 (SI 2015/1946)* (**Finance Platform Regulations**). Both regulations, made on 26 November 2015, exercise powers granted under the Small Business, Enterprise and Employment Act 2015, and are designed to complement one another. Both instruments come into force on 1 January 2016.

Purpose behind regulations

In the explanatory memoranda published with the regulations, HM Treasury cites that the largest four banks account for 80 per cent of UK SME main banking relationships, which it believes is bad for consumers and business. The memoranda point to such failings as a lack of information about the creditworthiness of SMEs, and alternative providers of finance not being aware of the existence of smaller businesses seeking finance, and vice versa. Through the regulations, the Treasury hopes to address, what it describes as, the market failure of imperfect information that is impeding SMEs' ability to access the finance they need to grow and compete.

Key requirements

The Credit Information Regulations will require banks to share information on their SME customers with credit reference agencies (**CRAs**). Those CRAs will be required to provide equal access to that information to finance providers, and provide the information to the Bank of England. The Finance Platforms Regulations will require banks to refer a SME customer to finance platforms if the SME has made an unsuccessful finance application to a bank. The finance platforms will then be required to provide, upon request, finance providers with data on the SME.

To minimise the effect of these new requirements on firms employing up to 20 people, the Treasury will have the power to designate banks, to which the legislation will apply, based on SME lending market share. Only the largest banks will be affected by the legislation in order not to increase barriers to entry for smaller and challenger banks or alternative finance providers. Both regulations also extend the remit of the Financial Ombudsman Service to enable a complaint to be referred to it in relation to designated CRAs and designated finance providers, respectively.

FCA CONSULTS ON CHANGES TO PPI COMPLAINT HANDLING RULES – NEW DEADLINE PROPOSED

In the previous edition of Exchange – International, we reported on the long-awaited FCA response to the Supreme Court's decision in *Plevin v Paragon Personal Finance Ltd* which ruled that a failure to disclose the commission payable by the insurer to the broker in relation to payment protection insurance (**PPI**) could amount to an unfair relationship arising between the insurer and consumers under section 140A of the Consumer Credit Act 1974. On 26 November 2015 the FCA issued *CP15/39: Rules and guidance on payment protection insurance complaints* proposing changes to rules and guidance on PPI complaints. The consultation paper is of most interest to consumers but is also of interest to claims management companies, who take forward complaints about PPI on behalf of consumers, and to firms selling PPI.

The consultation paper sets out, and asks for views on the following proposals.

PPI Complaints Deadline

The FCA proposes creating a new rule that would set a deadline by which consumers would need to make PPI complaints or else lose their right to have them assessed by firms or by the Financial Ombudsman Service. The FCA, after considering a wide range of deadlines, concludes that the deadline should be set at two years as it *"offers the right balance between fairness and urgency, allows for the delivery of an effective consumer communications campaign and is long enough to allow the monitoring of the campaign".* If the proposals are adopted, the FCA would therefore make the deadline rule in 2016 and the deadline would be two years after the making of the rule, in 2018.

The proposals also include an FCA-led communications campaign designed to inform consumers of the deadline and a new fee rule on funding this consumer communications campaign.

Plevin

The consultation paper proposes new rules and guidance on the handling of PPI complaints in light of the Supreme Court's decision in Plevin, which was published in November 2014. The FCA proposes that a failure to disclose a commission of 50% or more gives rise to an unfair relationship. Firms would be required to pay redress when an unfair relationship has arisen.

It is also proposed that the deadline applies to PPI complaints falling within the scope of the proposed rules and guidance on Plevin.

The consultation closes on 26 February 2016 after which a policy statement will be published by the FCA setting out the final rules. In the interim, firms are expected to continue to progress those PPI complaints that would not be affected by the proposed rules and guidance on Plevin. In respect of PPI cases currently being looked at by firms which will be affected by the new rules, firms may explain to complainants that they cannot provide a final response.

FCA ISSUES GUIDANCE ON FIRMS OUTSOURCING TO THE CLOUD AND OTHER IT PROVIDERS

On 12 November 2015, the FCA published a guidance consultation (*GC15/6: Proposed guidance for firms outsourcing to the 'cloud' and other third-party IT services*) to clarify various requirements imposed on firms where outsourcing to the 'cloud' and other third-party IT services. This is in response to uncertainty on how FCA rules might be applied to cloud-based outsourcing. If the guidance were adopted, the FCA would expect firms to use it to inform their systems and controls on outsourcing. The FCA stresses that the guidance would not be exhaustive and should not be read in isolation. However, compliance with it will generally indicate compliance with other FCA rules or other requirements to which the proposed guidance relates.

The high-level regulatory obligations on outsourcing require a firm to appropriately identify and manage the operational risks associated with its use of third party outsource providers, including undertaking due diligence prior to making a decision on outsourcing. This proposed guidance is intended to help firms effectively oversee all aspects of the life cycle of their IT outsourcing arrangements. This covers making the decision to outsource to cloud-based providers, selecting an outsource provider, the on-going monitoring of its outsourced activities and exiting an outsourcing arrangement.

In the consultation guidance, the FCA sets out a table with a number of areas for firms to consider when outsourcing. Some of the key areas include legal and regulatory considerations, risk management, oversight of service providers and the relationships between them, data security, effective access to data and business premises, continuity and business planning, resolution and exit plan. One area of difficulty in relation to oversight of cloud-based outsourcing is enabling effective access to data and business premises for the regulator. In the guidance consultation, the FCA makes various proposals for it to be able to attend and inspect the premises of outsourcing providers, something providers of cloud-based outsourcing have, in the past, been reluctant to grant.

The PRA also published a note, *Outsourcing functions to the Cloud*, in relation to cloud outsourcing, in which it states that it is working closely with the FCA on matters relating to the cloud and other types of outsourcing. The note provides that dual-qualified firms, which are seeking to outsource to the cloud should refer to the PRA Rulebook and notify regulators of anything they would reasonably be expected to be notified of.

The FCA states in the guidance consultation that firms should consider this guidance in the context of their overarching obligations under the regulatory system. The consultation will be for a period of three months and responses are required not later than 12 February 2016, with the likely publication of the final guidance on the FCA website soon after.

FCA CONSULTS ON UK IMPLEMENTATION OF MAR

On 5 November 2015, the FCA published a consultation paper (*CP15/35: Policy proposals and Handbook changes related to the implementation of the Market Abuse Regulation (2014/596/ EU)*), which sets out proposed changes to FCA rules governing the UK civil market abuse regime, in order to align the UK regime with the provisions of the EU Market Abuse Regulation (2014/596/ EU) (**MAR**), which takes effect, for the most part, on 3 July 2016.

MAR Overview

MAR will repeal and replace the existing EU Market Abuse Directive (2003/6/EC) (**MAD**), which currently governs the EU-wide civil market abuse regime. MAR became law on 2 July 2014 and one of its key purposes is to align the EU market abuse regime with the scope of the second Markets in Financial Instruments Directive (**MiFID II**), both in terms of the trading venues and financial instruments to which the regime will apply. Unlike MAD, which only applied to activities in relation to trading carried out on regulated markets, the scope of MAR will be wider in that it will also apply to activities in relation to financial instruments traded on multilateral trading facilities (**MTFs**) and organised trading facilities (**OTFs**). Furthermore, the scope of MAR will cover any other conduct or action which can have an effect on

financial instruments, irrespective of whether it takes place on a trading venue. MAR will also widen the range of financial instruments that fall within scope of the EU market abuse regime, again aligning this with the scope of MiFID.

The majority of the provisions of MAR take direct effect in each EU Member State on 3 July 2016. However, the widening of the scope of the market abuse regime to cover MTFs and OTFs is set to be delayed until 3 January 2017, which is the current implementation date for MiFID II.

Proposed changes to the existing UK Market Abuse Regime

As a Directive, MAD has indirect effect on the laws of each Member State and, as such, each Member State had to incorporate the provisions of the Directive into its own domestic legislation when it came into force. As a Regulation, MAR, which will repeal and replace MAD, has direct effect on the laws of each Member State and, therefore no transposition of its provisions into domestic law will be necessary before implementation in July 2016.

However, certain legislative provisions and FCA Handbook rules and guidance will need to be amended or repealed so that the UK market abuse framework becomes compliant with the provisions of MAR. The Consultation Paper sets out proposed changes to the Handbook which the FCA considers will be necessary in order to comply with and complement the new MAR regime. As a general point, the FCA intends to retain the structure and content of the Handbook where there is no conflict with MAR. Nevertheless, significant changes will be necessary in order to align the regime with MAR. The Consultation Paper highlights the more significant changes to the Handbook proposed by the FCA, which are summarised below. The FCA seeks feedback on its policy proposals and also invites comments on the changes proposed in Article 17 regarding public disclosure of inside information, and Article 19 regarding managers' transactions.

Disclosure Rules and Transparency Rules

The Treasury intends to amend the Financial Services and Markets Act 2000 (**FSMA**) in order to remove the FCA's powers to make the Disclosure Rules. As such, the Consultation Paper contains a proposal to change the Disclosure Rules and Transparency Rules into disclosure guidance, which will signpost the reader to relevant MAR provisions.

Model Code

The Model Code currently forms part of the Listing Rules. In its Consultation Paper, the FCA recognises that the Model Code is partially incompatible with MAR in relation to close periods (the periods of time before regular results announcements of traded companies during which persons discharging managerial responsibilities (**PDMRs**) may not deal in company shares). The Model Code will be replaced with new guidance for use by firms when developing processes to allow PDMRs to apply for clearance to deal in company shares.

Code of Market Conduct

Section 119 of FSMA currently requires the FCA to create a Code of Market Conduct, which forms part of the Handbook. The Code offers guidance for determining whether or not behaviour amounts to market abuse, along with evidential provisions. The Treasury intends to ask Parliament to remove section 119, which will change the legal status of the Code. The FCA has reviewed the Code in order to determine which provisions should be reinstated as guidance under the FCA's general guidance powers, and which are incompatible with MAR and therefore should be removed.

MAR Implementation Options

The Consultation Paper also sets out the FCA's current proposals in respect of two areas of MAR which offer different implementation options to Member States.

Article 17: Public Disclosure of Inside Information

Article 17 of MAR requires issuers to inform the public of inside information which directly concerns the issuer. This is a protection designed to prevent insider dealing and the misleading of investors.

As is the case under the existing MAD regime, issuers may delay the disclosure of such inside information where:

- immediate disclosure is likely to prejudice the legitimate interests of the issuer;
- delay of disclosure is not likely to mislead the public; and
- the issuer is able to ensure the confidentiality of that information.

MAR prescribes that where an issuer delays disclosure, it must inform the competent authority (which in the UK is the FCA) about the delay as soon as the disclosure is eventually made to the public. MAR also prescribes that an issuer must provide a written explanation of how the above conditions are met in certain circumstances; it is for each Member State to determine whether such explanation should be provided automatically when the competent authority is notified of a disclosure delay, or only when the competent authority requests such an explanation. The Consultation Paper states that the FCA is currently inclined to require an explanation to be given only where the FCA requests it, which would be in line with current market practice, and will minimise implementation costs.

Article 19: Managers' Transactions

MAR will require PDMRs within an issuer and their close associates to notify the issuer of all transactions in specified instruments, including shares and debt securities of the issuer, once they have carried out gross transactions over a threshold of €5000 per calendar year. MAR allows competent authorities to increase this threshold to €20,000. However, in order to do this, competent authorities must first notify ESMA of their decision, giving reasons that must specifically reference market conditions.

The FCA states that it is not currently aware of any market conditions that justify setting the higher threshold and therefore it currently proposes to adopt the lower, default threshold prescribed by MAR. The FCA seeks quantitative information on the number of transactions that would have to be notified under each threshold, in order to inform its final decision.

Next steps

The FCA consultation will be open until 4 February 2016. Alongside the changes to be made by the FCA, HM Treasury will take the lead role in amending the existing UK market abuse legal framework, as amendments are required to primary and secondary legislation before the implementation of MAR to align UK domestic law with the provisions of MAR. The existing FSMA market abuse regime and relevant Handbook provisions will continue in force until 3 July 2016, when most of the final amendments will be implemented.

FCA PUBLISHES FINAL RULES ON CHANGES TO THE APPROVED PERSONS REGIME FOR INSURERS NOT SUBJECT TO SOLVENCY II

On 16 December 2015, the FCA published a policy statement (*PS15/31: Final rules on changes to the Approved Persons Regime for insurers not subject to Solvency II*) providing final rules on changes made to the Approved Persons Regime for insurers that are not subject to the Solvency II Directive (non-directive firms, or **NDFs**). The rules are expected to come into force from 7 March 2016. The policy statement provides feedback on responses to *CP15/25: Changes to the Approved Persons Regime for insurers not subject to Solvency II: reforms for larger Non-Directive Firms, feedback on CP15/15, forms, consequentials and transitional aspects* published on 13 August 2015.

The Bank of England and HM Treasury's Financial Services Bill of October 2015, stated the intention of extending the Senior Managers & Certification Regime (**SMR**) for the banking sector to all Financial Services and Markets Act 2000 (**FSMA**) authorised firms by 2018. The FCA states that this does not affect the implementation of the revised Approved Persons Regime (Senior Insurance Managers Regime) for insurers in 2016, but it does mean it will be replaced by the SMR eventually. The changes to the Approved Persons Regime for insurers proposed by the FCA in the policy statement will pave the way for the proposed application of the SMR to insurers. The main provisions are summarised below.

Previous proposals

CP15/15: Changes in the Approved Persons regime for Insurers not subject to Solvency II, which was published on 27 March 2015, set out proposals for reforming the accountability regime for smaller insurance firms. The proposals intended to ensure robust accountability for senior staff following changes made by the Financial Services (Banking Reform) Act 2013 and the PRA's proposed reforms to the scope of the pre-approval

regime for NDFs. The PRA in *CP12/15: Senior Insurance Managers Regime: a streamlined approach for non-Solvency II firms* proposed to reduce the scope of its mandatory approval regime for small NDFs by streamlining the roles of individuals who need to be approved by the PRA to a single small senior manager function, while maintaining the chief-actuary and the with-profits actuary holders, who would continue to be subject to PRA pre-approval.

Key provisions

The FCA maintains the current scope of PRA regulations for executive functions. More specifically, after the feedback received, the FCA proposed to:

- remove all non-executive directors from the scope of a reformed Significant Influence Function (SIF) regime for small NDFs;
- give firms more time to prepare Scope of Responsibilities documents for all SIFs, pushing the requirement back to 7 March 2017;
- shorten the proposed mandatory record keeping period from ten years to six for small NDFs; and
- reform the regime for large NDFs.

The FCA and PRA proposed to categorise NDFs based on their size and apply proportionate rules to small and large NDFs. In CP15/25, the FCA stated, that "pursuant to the PRA's definition, a small non-directive insurer means a non-directive insurer in respect of which the value of assets relating to all regulated activities carried on by the firm as shown in its most recent reported annual accounts was £25 million or less. A large NDF is a non-directive insurer other than a small NDF".

Responses to this consultation paper sought clarification on whether the threshold of £25 million would be applied in relation to all assets of the firm or only to those assets held in relation to regulated activities. In the policy statement the FCA clarifies that only assets held in relation to regulated activities of the firm will be taken into account for the purposes of classification. This is in line with the PRA's provisions set out in *PS21/15: The Senior Insurance Managers Regime: a streamlined approach for non–Solvency II firms*, published in August 2015, and *PS26/15: the prudential regime, and implementation of the Senior Insurance Managers Regime, for non-Solvency II firms*, published in November 2015 and containing the PRA's final rules for non-Solvency II firms. According to the PRA's definition, the above assets will need to exceed £25 million for two consecutive year-ends before an NDF would be characterised as a large NDF.

Next steps

The FCA calls for firms to make all the necessary changes in order to comply with the regime by 7 March 2016.

HM TREASURY ON EXTENDING SMR AND CERTIFICATION REGIME

On 15 October 2015, HM Treasury published a paper, *Senior Managers and Certification Regime: extension to all FSMA authorised persons*, outlining the government's plans to extend the Senior Managers and Certification Regime (**SMR**) to all Financial Services and Markets Act 2000 (FSMA) authorised firms. In the paper the Treasury also outlines reforms to the SMR. In the last issue of *Exchange – International*, our *In Focus* piece reported that the FCA and PRA had published final and near-final rules on how the SMR was to be implemented.

This announcement from the Treasury represents a significant widening in scope of the SMR as it will initially apply only to banks and PRA-designated investment firms. However, the SMR will now be expanded to cover all FCA/PRA-authorised firms.

The SMR was already due to replace the Approved Persons Regime (**APR**) for banking sector firms (i.e. banks, building societies, credit unions and PRA regulated investment firms) from March 2016. The APR will remain in force for all other regulated firms after that date, until the full implementation of the SMR which is expected to be during 2018, and will have three main components.

Senior Managers Regime

This will directly replace the APR in its application to persons performing Senior Management Functions in a firm. Individuals already approved will be 'grandfathered' into relevant roles in the new regime, and any new senior manager appointment, or material change in role for those currently approved, will require approval.

Certification Regime

This applies to individuals who are not carrying out senior management functions but significant harm functions, which are functions capable of causing significant harm to the firm or its customers. Firms will be required to assess the fitness and propriety of these persons, and to formally certify this at least annually. However, appointments are not subject to approval by the regulator. The PRA uses the same basis to define individuals performing significant harm functions as it does for "material risk takers": persons whose actions could have a material impact on the risk profile of the firm. The FCA lists significant harm functions – or, certification functions – in its Senior Management Arrangements, Systems and Controls Sourcebook (SYSC):

- CASS (client money and assets) oversight
- Benchmark submission and administration
- Proprietary trader
- Significant management
- Functions requiring qualifications
- Managers of certification employees
- Material risk takers

Rules of Conduct

These will apply to senior managers, certified persons and certain other employees. For senior managers (and other approved persons), these rules replace the statements of principle made under the APR. The ability to make rules of conduct will also give regulators greater flexibility when formulating rules on important roles, such as those of non-executive directors.

Removal of reverse burden of proof

The SMR is to include a statutory duty of responsibility. An element of this duty is that it will supersede the 'reverse burden of proof' where a senior manager is liable if they cannot show that they took the steps that it was reasonable for a person in that position to take to prevent a breach in the areas of the firm for which they are responsible. Instead the regulator will need to show that the individual failed to take such steps. The Treasury policy paper states that this will be applied to all financial services firms, including banking sector firms instead of the initially proposed reverse burden of proof. This represents a substantial relaxation on what was considered a controversial aspect of the SMR.

Further provisions outlined by the Treasury include the removal of the requirement on banking sector firms to report to the regulator all known or suspected breaches of rules of conduct by any employees subject to those rules. HM Treasury describes this provision as "*inflexible*" and says that the removal will result in a reduction in costs. The paper also proposes a more flexible approach to grandfathering, allowing time limits on senior manager approvals to be varied in the same way as conditions, and technical changes to the application process for senior managers.

Reasons for expanding the regime

In its October 2015 paper, HM Treasury gave as a reason for expanding the regime, enhancing personal responsibility for senior managers whilst effectively and proportionately ensuring higher standards of conduct amongst key staff within the industry. The expansion will also, according to the Treasury, level the playing field for competition, and remove opportunities for regulatory arbitrage.

Next steps and time lines

The SMR will come into operation for banking sector firms on 7 March 2016. The Treasury forecasts that the proposed extension of the SMR will bring 42,000 consumer credit firms, 17,200 investment firms and 580 insurers within its remit and acknowledges that this will bring with it significant challenges. In light of this, the government intends for the newly extended regime to come into operation during 2018.

For more information read our October 2015 edition of *Exchange – International*.

PRA AND FCA NEW RULES ON WHISTLEBLOWING

On 6 October 2015, the FCA and the PRA published two policy statements both titled Whistleblowing in deposit-takers, PRA-designated investment firms and (*PS15/24* and *PS24/15*). The statements contain new rules designed to encourage a culture across firms in which individuals raise concerns and challenge poor practice and behaviour. The new regime represents a significant expansion on the scope of the previous rules and guidance on whistleblowing.

The new rules follow recommendations made in 2013 from the Parliamentary Commission on Banking Standards that banks should put in place mechanisms to allow employees to raise concerns internally, and appoint a senior person to take responsibility for the effectiveness of these arrangements. The FCA launched a consultation in February 2015 on the proposed rules of a new whistleblowing regime and most of the proposals were broadly supported by respondents.

The new regime will apply to UK deposit-takers with assets of £250 million or greater, to PRA-designated investment firms, and insurance and reinsurance firms within the scope of Solvency II Directive, including the Society of Lloyd's and managing agents. These firms are referred to as 'relevant firms' in the regime. The new regime will also act as non-binding guidance for all other firms regulated by the FCA. The new rules do not apply to UK branches of overseas banks, although the FCA has noted they will explore this possible extension in future consultations.

The new rules introduce a number of requirements which relevant firms will need to adopt. The key aspects of the new regime are set out below:

Requirement to appoint a whistleblowers' champion

Relevant firms must appoint a whistleblowers' champion, although they do not need to use this specific title for the individual. This function should be fulfilled by someone who is a non-executive director, although if a relevant firm's governance structure does not include such a position there is no requirement to create such a post. The appointed person must be subject to the Senior Managers Regime (**SMR**) or the Senior Insurance Managers Regime (i.e. a director or senior manager of an insurance firm). The whistleblowers' champion will have responsibility for "ensuring and overseeing the integrity, independence and effectiveness" of the firm's policies and procedures on whistleblowing. The whistleblowers' champion should have access to independent legal advice and training, along with sufficient information to carry out its responsibilities. However, the champions do not need to have a day-to-day operational role handling disclosures from whistleblowers, and they do not need to be based in the UK if they can perform their function effectively from elsewhere.

Requirement to adopt suitable whistleblowing arrangements

Relevant firms must adopt procedures to enable them to handle all types of whistleblowing disclosure, including anonymous disclosures, from all types of whistleblower (including, for example customers and employees). Whilst these procedures must be promoted to, amongst others, UK-based employees, there is no expectation for them to be promoted to anyone else, such as for example employees abroad. The procedures must ensure the effective assessment and escalation of disclosures, and whilst not all disclosures will result in investigative action, the consideration given to each disclosure should be properly recorded. The relevant firm's procedures for dealing with whistleblowing must be available in writing to UK-based employees, and appropriate training should be provided for UK-based employees, managers of UK-based employees, and employees responsible for operating the firm's internal arrangements. Importantly, the new rules do not place any regulatory duty on a relevant firm's staff to whistleblow, as respondents to the February 2015 consultation feared that this could put a whistleblower who feared reprisals in a difficult position. This concern is perhaps interesting given the protection that exists in legislation to prevent reprisals against employees who whistleblow.

Requirement to notify individuals about the FCA and PRA whistleblowing services

is no requirement to use the firm's internal processes in the first instance. Relevant firms must also ensure that their appointed representatives and tied agents inform their UK-based employees about the FCA whistleblowing services.

Requirement to prepare an annual report

Relevant firms must prepare a report, at least annually, for the board, which is available to the FCA and PRA on request, but which does not need to be made public. The whistleblowers' champion should oversee the preparation of the report.

Requirements concerning settlements with employees at employment tribunals

Relevant firms must include text in any settlement arrangements explaining the employee's legal rights, which should expressly state that employees may make protected disclosures if they wish. The rules further require that settlement agreements must not include any warranties for employees that they do not know any information that could form the basis of a protected disclosure, or require them to state whether or not they have made a protected disclosure. Relevant firms have discretion as to whether or not these provisions are included in employment contracts, and whether or not they request employment agencies to include this text in settlement agreements entered into with workers. Furthermore where an employment tribunal finds that a whistleblower has suffered detriment or been unfairly dismissed as the result of making a protected disclosure, the relevant firm must notify the FCA of this outcome.

Timeline

The new rules will come into force on 7 September 2016, while the requirement to appoint a whistleblowers' champion will take effect on 7 March 2016, the same date as the rest of the SMR. In the interim period the whistleblowers' champion will be responsible for overseeing the steps their firm takes to prepare for and implement the new regime.

FLOWS OF CONFIDENTIAL AND INSIDE INFORMATION

On 10 December 2015, the FCA published a Thematic Review (*TR15/13: Flows of Confidential and Inside Information*) on the flows of confidential and inside information. The review focussed on the debt capital markets and M&A departments of small to medium sized investment banks and how they managed confidential and inside information they receive and generate. The FCA did not test for market abuse, but considers it intrinsically linked to the subject of controlling information.

Key Points of TR15/13

The FCA found that that many senior managers could not explain the difference between confidential information and inside information, which suggests a lack of awareness of the risks of inappropriately handling inside and confidential information. Therefore, senior management should visibly champion adherence to firm principles about controlling flows of information and (as appropriate) take an active interest and role in training staff to practically apply regulatory requirements.

Assessing the circumstances that could present heightened regulatory and conduct risks should be at the centre of a firm's on-going risk assessment:

- The FCA noted that several firms had not sufficiently thought about risks of locating employees with conflicting roles or responsibilities in close proximity to each other, e.g. where deal trees (the firm providing services to more than one bidder in a competitive M&A transaction) are set up.
- Firms should also consider risks when their business changes or in light of market changes and developments.

Employees at all levels and across the lines of defence should understand their role in controlling flows of confidential and inside information, take responsibility for their conduct and escalate any concerns. Business heads acting in a supervisory capacity should take responsibility for controlling flows of information.

The FCA believes that the first line of defence can benefit from physical proximity of members of compliance on a day-to-day basis, but noted that there is a risk of the

compliance function taking on too much of the first line's responsibilities (which could result in the degree of challenge by compliance growing weaker).

In relation to sharing information:

- It is important that senior management and employees can explain the reason for deciding to share confidential information.
- Firms should ensure that access is limited to personnel who are expressly permitted to access the information, e.g. does the firm need to consider physical (separating private and public side functions as well as the firm's brokerage and prop trading desks) and/or electronic separation?

Where physical separation is not possible, the FCA will expect firms to use enhanced surveillance, including automated surveillance.

FCA CONSULTS ON MIFID II IMPLEMENTATION

On 15 December 2015 the FCA published a consultation paper (*CP15/43: Consultation Paper 1 on Markets in Financial Instruments Directive II*) regarding the implementation of the Markets in Financial Instruments Directive II (**MiFID II**) in the UK. MiFID II is expected to come into effect on 3 January 2017, although this date may be postponed. The consultation paper follows a consultation process initiated by the FCA in March 2015 (after HM Treasury published its views on the UK implementation of MiFID II) and a discussion paper (*DP15/3: Developing our approach to implementing MiFID II: conduct of business and organisational requirements*) published by the FCA on 26 March 2015, which outlines the FCA's approach to implementing aspects of MiFID II where it has discretion. Details on this can be found in issue 26 of the *Exchange – International* Newsletter.

The consultation paper covers issues related to FCA regulation of the secondary trading of financial instruments and consults on changes that need to be made to the FCA Handbook in light of the implementation of MiFID II. The FCA states that the full range of changes to the Handbook will be covered in subsequent consultation papers, when more information regarding MiFID II implementing measures, particularly the delegated acts, becomes available. Firms affected by MiFID II should consider these changes and provide the FCA with their feedback by 8 March 2016.

The main areas of the implementation proposals are set out below.

Regulated Markets

The MiFID II regulatory framework aims to make regulated markets (**RMs**) more transparent, reduce the risks of algorithmic trading and improve post-trade processes. This consultation paper proposes making changes to the Recognised Investment Exchanges sourcebook to include new obligations on the management body of a recognised investment exchange, and adopt adequate systems and controls regarding algorithmic, high frequency trading and direct electronic access. The FCA also proposes new sections to be included in the sourcebook regarding position reporting for commodity derivatives, the operation of data reporting service providers, the suspension and removal of financial instruments and provisions regarding trade transparency.

Multilateral Trading Facilities

MiFID II provisions align requirements imposed on multilateral trading facilities (**MTFs**) with those of RMs. In that context, RMs and MTFs that are of similar size will be subject to similar organisational requirements and regulatory oversight. The FCA proposes changes to its Handbook to ensure fair and orderly trading and efficient execution of orders on MTFs. The Code of Market Conduct which provides the relevant rules should be updated in order to impose new requirements for MTFs. These rules would require access to the MTF to be publicly available, non-discriminatory and based on objective criteria. Furthermore, MTFs would need to ensure that they manage conflicts of interest properly and that they have contingency plans in place to address any disruptions. Additionally, new rules would require MTFs to publish data on execution quality and maintain systems that manage risk properly. The FCA suggests that all MTFs should have at least three active members or users and restrict the operator from engaging in proprietary trading. The FCA also introduces additional obligations on trading suspensions, providing that a firm operating an MTF will have to comply with the rules on suspension or removal of financial instruments set out in MiFID II.

Organised Trading Facilities

MiFID II introduces this new category of trading venue, which is subject to the same requirements imposed on MTFs, as they are similar multilateral systems that, according to article 4(1)(23) of MiFID II, "*bring together third party buying and selling interests in financial instruments in a way that results in a contract*". These requirements include the obligation to trade fairly and in an orderly manner, maintain clear and non-discriminatory access rules, be able to suspend instruments from trading and ensure continuity under stress conditions. Transparency requirements that apply to organised trading facilities (**OTFs**) are the same as those applied to RMs and MTFs and require adequate pre and post-trade regimes, which will make public current bids and offers in the pre-trade process, and also the details of the transactions in the post-trade process. Firms operating OTFs and MTFs are also subject to similar financial resources requirements, as set out in Capital Requirements Directive IV. The introduction of OTFs will ensure that many transactions currently categorised as off-venue will be categorised as an OTF transaction, establishing an overall higher level of transparency in the market for financial instruments.

The FCA proposes that a separate chapter in the Code of Market Conduct of the FCA Handbook should be introduced, which will be dedicated to the functioning of OTFs, in order to make its provisions more useable and accessible for all OTF operators.

Systematic Internalisers

Provisions in relation to systematic internalisers (**SIs**) are included in the directly-applicable component of the MiFID II package: the Markets in Financial Instruments Regulation (**MiFIR**). MiFID II retains the SI regime but introduces two key changes: the expansion of financial instruments within the scope of the regime, and specific pre-trade transparency requirements for the trading of bonds and derivatives. MiFID II provisions also include obligations regarding public quotes and thresholds for identifying SIs.

In light of the direct applicability in the UK of the SI provisions, the FCA proposes to only amend the Code of Market Conduct (which transposes the existing MiFID provisions on SIs) in respect of the references in the scope and purpose set out in the Handbook and the reporting obligation imposed on firms which operate as SIs.

Transparency

The existing MiFID provisions include transparency requirements for equities only, rendering non-equity instruments beyond scope. MiFID II introduces significant changes to transparency requirements, extending transparency from shares to other equity-like instruments such as depositary receipts, exchange-traded funds, certificates and non-equity securities, such as bonds, structured finance products, derivatives and emission allowances. The transparency requirements apply to financial instruments that are admitted to trading or traded on a trading venue, extending the scope to include RMs, MTFs and OTFs for non-equities.

The MiFID II provisions on transparency are included in MiFIR. The FCA proposes to erase existing provisions from its Handbook which refer to transparency (such as post-trade transparency requirements for transactions that take place off venue) and provide links to MiFIR provisions. The FCA also proposes to make amendments to its Handbook in order to include provisions regarding the expansion of transparency requirements to equity-like and non-equity markets.

MiFID II allows competent authorities to have some discretion in two key areas. These are the granting of waivers from pre-trade transparency requirements to trading venues, and authorising deferrals of post-trade transparency requirements under certain circumstances.

Waivers

To allow some flexibility whilst ensuring pre-trade transparency, MiFID II provides the same four types of waiver in relation to equity and equity-like instruments as those found in the current legislation. These are a waiver for systems matching orders on the basis of a reference price, systems that formalise negotiated transactions, orders that are large in scale, and orders held in an order management facility pending disclosure. The FCA proposes to use its powers for granting waivers to RMs and MTFs trading equity and equity-like instruments, subject to them meeting the waiver criteria set out in the legislation.

MiFID II expands the scope of MiFID to include non-equity instruments and therefore provisions for non-equity waivers are introduced in the legislation text. Under MiFID II, regulators are able to grant waivers to four types of instruments:

- orders that are large in scale;
- orders held in an order management facility pending disclosure;
- actionable indication of interest in request-for-quote and voice trading systems; and
- derivatives that are not subject to the trading obligation under article 28 of MiFIR, and other financial instruments for which there is no liquid market.

The FCA supports greater transparency in non-equity markets, which are usually more illiquid and proposes to grant these waivers according to the conditions set by the Regulatory Technical Standards.

In relation to the application process, MiFID II establishes a new process to grant waivers that formalise the current European and Markets Authority (**ESMA**) approach and provide more scrutiny. The FCA is ready to adopt these changes, which include notification of other competent authorities and ESMA for the intended use of each particular waiver, at least four months before the waiver is to be used.

Equity deferrals

MiFID II provides regulators with the power to grant post-trade deferrals of publication transactions. Equity deferrals provisions remain the same as the existing MiFID rules, providing authorisation of deferrals to large scale transactions. As for non-equity deferrals, the FCA welcomes MiFID II proposals to grant deferrals to transactions which are large in scale, for financial instruments for which there is not a liquid market or which are above a specific size, and for package transactions. The FCA also proposes to require trading venues to provide additional information to the public during the deferral period, in order to further enhance transparency.

Market data

MiFID II expands the scope and depth of transaction reporting, covering a wide range of transactions and requiring more information to be reported on each transaction. The new rules establish data reporting service providers (**DRSPs**) as a new category of firm, which include approved reporting mechanisms for submission of transaction reports to competent authorities, approved publication arrangements for publication of OTC trade reports and consolidated tape providers. Similar requirements are currently in place under MiFID, but MiFID II provides more detailed organisational requirements, providing a new authorisation and supervision framework. Detailed regulatory obligations of DRSPs are already contained in UK government legislation, which provide directly applicable technical standards. The FCA proposes to include a new chapter in its Handbook on the new DRSP category of firms and their responsibilities in order to reflect the wider scope of market data reporting requirements. The FCA also makes two additional proposals: to exclude managers of collective investment undertakings and pension funds from the transaction reporting obligation, and enhance connectivity of the FCA's systems requiring certain entities to provide the FCA with transaction reports and reference data.

Algorithmic and high frequency trading requirements

MiFID II introduces provisions regarding algorithmic and high frequency trading (**HFT**) for MTFs and OTFs. Algorithmic or HFT trading is deemed to present risks such as those associated with trading systems experiencing higher demands without sufficient capacity. The new rules acknowledge these risks and propose to include provisions that are able to ensure orderly trading under severe market stress.

The FCA proposes changes to its Handbook to introduce new sections to MAR. These would relate to matters including business continuity, systems and controls, financial crime and market abuse. New provisions would include high-level requirements for investment firms engaging in algorithmic trading, requirements for high frequency traders, requirements for those providing direct electronic access, and new rules for a person who acts as a general clearing member.

Passporting

Passporting provisions are currently available under MiFID II, which defines passporting as "the ability of an investment firm authorised in one EEA country to provide investment services, or perform investment activities, in another EEA country without requiring additional authorisation". MiFID provisions cover cross-

border activity and the establishment of branches. MiFID II introduces significant changes to the passporting regime in the following three key areas.

- Investment services and activities would be expanded to include the operation of an OTF. The new rules also widen the scope of the range of instruments covered to include a new category of emission allowances.
- The range of provisions that a 'host' country regulator is responsible for when an investment firm is passporting through a branch (or when tied agents are appointed) in another country would be expanded. This is in order to reflect new provisions in MiFID II regarding the obligation of investment firms to trade in liquid shares on a trading venue or a systematic internaliser. New provisions also impose obligations on firms to provide data for transparency calculations to regulators.
- The templates for notifications for firms passporting applications are to be revised in order to enhance harmonisation.

The FCA proposes to make the necessary changes to the Supervision Manual of its Handbook to include these provisions.

Principles for Businesses (PRIN)

MiFID II extends the scope of the conduct of business obligations to include firms that provide investment services to firms that carry on business with clients categorised as eligible counterparties (**ECPs**). It also excludes local authorities from the list of entities that can be categorised as ECPs. The FCA proposes to make the necessary changes to its Handbook in order to extend the application of some of PRIN to firms that conduct business with clients that are categorised as ECPs.

Perimeter Guidance manual (PERG)

MiFID II introduces several changes in relation to the scope of investment services and activities, financial instruments and exemptions. including a new financial instrument category of emission allowances. The FCA proposes to issue guidance in order to reflect these changes. Changes in PERG will include guidance on:

- the new investment service for operating an OTF and the associated definition of multilateral system;
- the extension of the MiFID service of executing client orders to cover issuance of securities and further explanation on why the issue of an ordinary commercial company's securities should be exempt
- the fact that the matched principal exclusion no longer applies to the MiFID dealing on own account definition, although it remains relevant for prudential capital purposes. Matched dealing refers to circumstances where the facilitator interposes between the buyer and seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction and both sides of the transaction are executed simultaneously at a price where the facilitator makes no profit or loss;
- structured deposits and how they fit into the MiFID and Regulated Activities Order perimeters. Although structured products are not financial instruments within the scope of MiFID II, the extension of conduct requirements to banks and investment firms dealing with them created the need for further perimeter guidance; and
- changes to the dealing on own account exemption from the MiFID perimeter.

The FCA states that a later consultation will be launched to address issues relating to the full range of changes to the FCA Handbook when more information regarding MiFID II implementing measures, particularly the delegated acts, becomes available.

Next steps

The consultation closes on 8 March 2016. The FCA will publish a policy statement in the first half of 2016, and also intends to consult on further MiFID II changes to its Handbook during this time.

ENFORCEMENT

COMPLAINTS COMMISSIONER IDENTIFIES SERIAL FAILINGS AT FCA

The Complaints Commissioner has published a final report recommending that the FCA *"offers a full apology for its serial failings"* in relation to a complainant who alleged improper practices at HFC Bank Limited, and subsequently, HSBC. The report, published on 3 December 2015, also welcomes the FCA's announcement to reconsider not taking further action in relation to the complaint.

Background

The complainant, Mr Nicholas Wilson, alleged that HFC Bank, and later HSBC after it acquired HFC, had overcharged a large number of customers who had defaulted on credit cards. Between 2003 and 2010, HFC charged such customers based on a percentage of the sum to be recovered, rather than on the basis of the actual cost of recovering the debt. The Office of Fair Trading (**OFT**) established the impropriety of this practice in 2010, and measures were agreed with HFC to discontinue it. Mr Wilson believed that this was not sufficient to redress the consumers affected, and contacted the FCA's predecessor – the FSA – in 2012, voicing concerns. What followed were, in the words of the Complaints Commissioner, *"a series of events bordering on the farcical"* where the FSA, and subsequently the FCA, failed to refer the matter to the OFT when it should have done so, before wrongly blaming Mr Wilson for not referring the matter to the OFT himself.

In February 2014 Mr Wilson submitted a Freedom of Information Act (**FoIA**) request to the FCA seeking details of how his complaint against HSBC had been handled. The FCA approached HSBC for additional information about Mr Wilson's allegations prior to responding to the request. When the FCA did respond to the request on 10 April 2014, it included a direct quote from information provided by HSBC without either attributing the quote or verifying its accuracy. The Complaints Commissioner goes on to write:

"It is clear that the FCA made an error and was negligent in the manner in which it responded to your FoIA request. It is also clear that the error is made worse by the fact that the information supplied by HSBC was wrong and – to anyone familiar with the matter – obviously wrong."

Mr Wilson claimed that this amounted to collusion between the FCA and HSBC. However, the Complaints Commissioner did not accept this claim as it could find no evidence of a deliberate attempt to mislead Mr Wilson.

Decision

The FCA informed the Complaints Commissioner that it would revisit whether to take further action in relation to Mr Wilson's complaint. In its report, the Commissioner concluded that the failures in handling Mr Wilson's complaints were serious, before calling for a full analysis by the FCA of the harm caused by these debt collection practices, as well as the number of customers affected.

FCA FINES FINANCE DIRECTOR OF INVESTMENT FIRM FOR FAILING TO COMPLY WITH APER RULES

On 21 September 2015, the FCA fined Craig McNeil, a former finance director of Keydata Investment Services Ltd (**Keydata**) £350,000 and prohibited him from performing any significant influence function (**SIF**) in relation to any regulated activity carried on by any authorised or exempt person, or exempt professional firm, as a result of his failure to comply with Statements of Principle 4 and 6 of the FCA's Statements of Principle and Code of Practice for Approved Persons (**APER**).

Keydata designed and sold investment products to retail investors through independent financial advisers. The products were underpinned by Keydata's investments in bonds issued by Luxembourg special purpose vehicles (**SPVs**), which in turn invested in portfolios of life settlement policies. Following Keydata's entry into administration in June 2009, its administrators discovered that one of the SPVs, SLS Capital SA (**SLS**), had failed to make certain payments due to Keydata since early 2008. Following SLS's failure to make these payments, Keydata chose to provide £4.2 million of income payments to investors from its own company resources. Mr McNeil permitted the release of Keydata's corporate funds and failed to ensure that Keydata reported the matter to the FCA.

The FCA found that Mr McNeil failed to:

- Comply with Statement of Principle 4, which provides that an approved person must deal with the FCA and other regulators in an open and cooperative way, disclosing all necessary information that the regulatory authorities would reasonably expect to have been given notice. More specifically, Mr McNeil failed to disclose to the FCA information regarding the failure of SLS to make income payments due to Keydata, which resulted in posing real risk to investors in the SLS products.
- Act with due skill care and diligence, as Statement of Principle 6 provides. Mr McNeil permitted Keydata to enter into a complex collateral portfolio transaction, without having a clear understanding of the transaction and the risks involved. The transaction was supposed to be in Keydata's commercial interests and provide security for its exposure to SLS's missed payments. However, although £500,000 of Keydata's corporate funds were released, Keydata failed to obtain any security.

Due to these failings, the FCA has concluded that Mr McNeil is not a 'fit and proper' person, as defined in the APER rules, and as such should not be permitted to exercise a significant influence function in relation to any regulated activity carried on by an authorised person, exempt person or exempt professional firm. Mr McNeil qualified for a 30% reduction in penalty from £500,000 to £350,000 for agreeing to settle at an early stage of the FCA's investigation.

FCA FINES AND BANS FORMER INVESTMENT ANALYST FOR APER FAILINGS

On 17 November 2015, the FCA fined Mothahir Miah, a former investment analyst at Aviva Investors Global Services Ltd (**Aviva**) £139,000 and prohibited him from performing any significant influence function (**SIF**) in relation to any regulated activity carried on by any authorised or exempt person, or exempt professional firm, as a result of his failure to comply with Statement of Principle 1 of the FCA's Statements of Principle and Code of Practice for Approved Persons (**APER**).

The FCA found that Mr Miah had failed to behave with honesty and integrity, in line with its customers' interests when carrying out his controlled function. From 1 January 2010 to 31 October 2012, Mr Miah exploited weaknesses in Aviva's trading systems on numerous occasions by deliberately delaying the booking and allocation of trades in order to assess their performance and then cherry-pick trades in favour of hedge funds. Thus, Mr Miah allocated trades that benefited from favourable intraday price movements to hedge funds that paid performance fees, and trades that had not benefited to certain long-only funds that paid lower or no performance fees. In its final notice, the FCA stated Mr Miah knew his practice was dishonest and abusive, but continued doing so because he wanted to prove his trading ability to his colleagues and increase his prospects of being promoted, and was driven by a performance-focused culture that dominated the fixed income business.

Previously, on 24 February 2015, the FCA ordered Aviva to pay £17,607,000 to compensate a number of long-only funds for failing to keep adequate risk management systems in place and address conflicts of interest in relation to those breaches.

The FCA notes that the fine imposed on Mr Miah is reduced due to his early admission and level of cooperation. The FCA also expressed that it is minded to revoke the prohibition any time after five years, on the application of Mr Miah, unless there is new evidence that he is not fit and proper.

PRA FINES BANK FOR OUTSOURCING FAILINGS

The PRA has fined R.Raphael & Sons Plc (**Raphaels Bank**) £1,278,165 for potentially putting its safety and soundness at risk by failing to properly manage its outsourcing arrangements. This was announced in a press release, published along with the final notice, on 27 November 2015. The basis for the penalty was contravention during the relevant period between 18 December 2006 and 1 April 2014 of Principle 3 of the PRA's Principles for Business. This requires a firm to take reasonable care to organise and control its affairs

responsibly and effectively and have in place adequate risk management systems. Due to its agreeing to settle at an early stage of the investigation, Raphaels Bank qualified for a 30% discount from what would have been a fine of £1,825,950.

Outsourcing failings

Raphaels Bank had entered into a joint venture with another company in its group which entailed the outsourcing to that company of the provision of ATMs and the performance of certain ATM management and financing functions. The PRA determines in its final notice that appropriate procedures for this outsourcing arrangement, including necessary written agreements, were not correctly put in place. The company providing the ATMs subsequently transferred funds from Raphaels Bank to itself in order to deal with cash flow problems, without the knowledge or prior consent of Raphaels Bank. The largest balance of the transfers from 2011-2014 – the years for which records were available – were £5.4 million, £4.1 million, £6.45 million and £9.2 million respectively. The PRA adjudged that the impact that this had on Raphaels Bank's regulatory capital exposed it to the company in question to the extent that the bank would have experienced severe financial repercussions had the company become insolvent.

Andrew Bailey, Deputy Governor for Prudential Regulation at the Bank of England, and CEO of the PRA, said that Raphaels Bank did not know what its capital position was or who it was exposed to as a result of the lack of controls. Raphaels Bank's exposure to the wider group of companies was more than 25% of its capital resource, and these circumstances were cited by the PRA as justification for levying a fine, which, according to Mr Bailey, is an unusual step for the PRA to take.

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FEDERAL RESERVE PROPOSES NEW REQUIREMENTS FOR GLOBAL SYSTEMICALLY IMPORTANT BANKS

Citing the Dodd-Frank Act's objective of ending "too big to fail", the Federal Reserve released a proposed rule (**Proposed Rule**) during the final quarter of 2015 to impose new requirements on the largest financial institutions with operations in the US – the so-called global systemically important banks (**GSIBs**). The Proposed Rule would apply to eight GSIBs in the US and to the US operations of foreign GSIBs. The new requirements fall into four categories:

- A requirement that GSIBs issue a minimum amount of long-term debt (**LTD**);
- A requirement that GSIBs maintain a minimum amount of total loss-absorbing capacity (**TLAC**);
- A "clean holding company" requirement prohibiting a Covered BHC or Covered IHC (defined below) from entering into certain types of transactions discussed below; and
- A requirement that banking institutions subject to Federal Reserve supervision deduct unsecured debt issued by a Covered BHC or Covered IHC from their regulatory capital calculations.

Nonbank systemically important financial institutions subject to Federal Reserve supervision would not be covered by any of the Proposed Rule's requirements.

Long-term debt

For US firms, the top-tier bank holding company of a GSIB (**Covered BHC**) would be required to issue and maintain eligible LTD instruments to external third-party investors, to facilitate the process of recapitalising the firms' critical operations upon failure, in an amount not less than the greater of (a) the sum of 6% plus the Covered BHC's GSIB surcharge multiplied by the Covered BHC's total risk-weighted assets, or (b) 4.5% of the Covered BHC's total leverage exposure. To be eligible, an LTD instrument may not have any complex features that would reduce its ability to absorb losses, including features that would cause the instrument to be treated as a structured note or which would have terms that are credit-sensitive, permit conversion to equity, or provide certain rights to accelerate payment. Eligible LTD instruments must be unsecured, governed by US law, and issued directly by the Covered BHC. In addition, eligible LTD instruments must have a maturity greater than one year and any LTD instrument with a remaining maturity of between one and two years is subject to a 50% reduction for purposes of calculating compliance with the applicable percentage requirements. Covered BHCs would be required to make certain public disclosures of the fact that their LTD would be expected to absorb losses ahead of other liabilities, including the liabilities of the Covered BHC's subsidiaries.

For foreign firms, the Proposed Rule would apply to any intermediate holding company required to be formed under the Federal Reserve's enhanced prudential standards rule that is controlled by a top-tier foreign banking organisation that the Federal Reserve determines would be designated as a GSIB under its GSIB surcharge rules or the Basel Committee on Banking Supervision's assessment methodology (**Covered IHC**).

Unlike Covered BHCs, Covered IHCs would be required to issue the necessary debt instruments to a foreign parent company (but not necessarily to the top-tier entity) rather than to external, third-party investors. A Covered IHC would be required to maintain eligible internal LTD in an amount not less than the greater of (a) 7% of its total risk-weighted assets; (b) 3% of its total leverage exposure; or (c) 4% of its average total consolidated assets, as calculated for purposes of the US tier 1 leverage ratio. The LTD eligibility requirements for Covered IHCs are generally the same as those for Covered BHCs, with the additional requirements that LTD instruments must be issued to a foreign parent entity, must be subordinated to all of the Covered IHC's third-party liabilities, and must include a contractual provision, approved by the Federal Reserve, permitting the Federal Reserve to require the Covered IHC to cancel the LTD or convert it to tier 1 capital.

Total loss-absorbing capacity

For US firms, the Proposed Rule defines TLAC as the sum of a Covered BHC's tier 1 capital issued directly by the Covered BHC and its eligible LTD instruments. To meet the TLAC requirement, each Covered BHC must maintain outstanding TLAC in an amount not less than

the greater of (a) 18% of its total risk-weighted assets, or (b) 9.5% of its total leverage exposure. Thus, while a GSIB would be required to meet the LTD requirement described above, it may meet the TLAC requirement by further increasing its LTD, increasing its tier 1 capital, decreasing its total risk-weighted assets or total leverage exposure, or through some combination thereof.

In addition, each Covered BHC would be required to hold a TLAC buffer of 2.5% of risk-weighted assets composed solely of tier 1 capital. However, under existing capital requirements, GSIBs are already required to maintain a common equity tier 1 capital conservation buffer equal to 2.5% of risk-weighted assets. Thus, any Covered BHC that meets existing capital requirements and the existing capital conservation buffer would not need to increase its tier 1 capital to meet the TLAC buffer requirement.

For foreign GSIBs, TLAC is defined as the sum of a Covered IHC's tier 1 capital issued to a foreign parent entity that controls the Covered IHC and its eligible LTD instruments. The amount of TLAC that a Covered IHC is required to maintain depends on whether the Covered IHC (or any of its subsidiaries) is expected to be resolved in a failure scenario, rather than being maintained as a going concern while a foreign parent entity is instead resolved. If the Covered IHC will itself be resolved, it must maintain TLAC in an amount not less than the greater of (a) 18% of the Covered IHC's total risk-weighted assets; (b) 6.75% of the Covered IHC's total leverage exposure (if applicable); or (c) 9% of the Covered IHC's average total consolidated assets, as calculated for purposes of the US tier 1 leverage ratio. If the Covered IHC is not expected to enter resolution itself, it would be required to maintain TLAC in an amount not less than the greater of (a) 16% of the its total risk-weighted assets; (b) 6% of its total leverage exposure; or (c) 8% of its average total consolidated assets. Covered IHCs are required to hold a TLAC buffer of 2.5% of risk-weighted assets composed solely of tier 1 capital, but, like Covered BHCs, they would not need to increase their capital if they are already in compliance with existing requirements.

Note, the Proposed Rule's TLAC and LTD requirements represent a different approach from that taken under the TLAC proposal produced by the Financial Stability Board (**FSB**). The FSB's proposed standard included an expectation that GSIBs would meet at least one-third of the TLAC requirement with LTD rather than equity, but did not contain any specific LTD requirement on a standalone basis. Thus, while the Proposed Rule permits some flexibility in determining how to meet the TLAC requirement, it contains a more stringent requirement that TLAC include a specified minimum amount of LTD. This distinction may be particularly relevant for foreign GSIBs operating under a more permissive TLAC standard outside the US.

Clean holding company

In addition to the LTD and TLAC requirements, both Covered BHCs and Covered IHCs would be subject to "clean holding company" requirements that prohibit them from engaging in certain transactions that impede an orderly liquidation. In general, this would prohibit them from issuing short-term debt, qualified financial contracts, certain guarantees of subsidiary liabilities, or liabilities guaranteed by a subsidiary. With regard to US GSIBs, the Proposed Rule would also cap the total value of each Covered BHC's non-TLAC third-party liabilities that can be *pari passu* with, or junior to, its LTD at 5% of the value of its total TLAC. Like the requirement that Covered IHC LTD be subordinated to a Covered IHC's third-party liabilities, the 5% cap is intended to address any concerns with a Covered BHC's unsecured creditor hierarchies.

Capital deductions

With the goal of limiting the risk of financial sector contagion, the Proposed Rule would impose deductions in the regulatory capital treatment of investments in unsecured debt instruments issued by Covered BHCs, including both LTD instruments and other unsecured debt instruments. Under the Proposed Rule, all Federal Reserve-regulated institutions, including state member banks, BHCs, savings and loan holding companies, and IHCs, with over $1 billion in total consolidated assets, must deduct such instruments from their regulatory capital calculations. As proposed, the requirement would not apply to institutions regulated by the FDIC or the OCC. However, the preamble to the Proposed Rule states that the Federal Reserve will consult with the FDIC and OCC to ensure consistent treatment among

all banking institutions; therefore, any final rule will likely apply to other types of depository institutions in the future.

If finalised, the proposed TLAC requirement would become effective on January 1 2019, with a phase-in period between that date and January 1 2022. The LTD, clean holding company and capital deduction requirements would become effective January 1 2019. Parties interested in commenting on the Proposed Rule should be aware that comments are due no later than February 1 2016.

FDIC PROPOSES TO INCREASE RESERVE RATIO THROUGH SURCHARGE ON LARGE BANKS

The FDIC's Deposit Insurance Fund (**DIF**) is funded through quarterly assessments on insured banks and is reduced by the FDIC's operating expenses and losses associated with resolving failed banks. The amount of the DIF must be equal to or greater than the minimum reserve ratio, which is expressed as a percentage of total estimated insured deposits. Section 334 of the Dodd-Frank Act authorises the FDIC to implement measures necessary to raise the DIF from a minimum reserve ratio of 1.15% to 1.35% by September 30, 2020. Section 334 further requires the FDIC to offset the impact of raising the reserve ratio on insured depository institutions with less than US$10 billion in total consolidated assets (**Small Banks**). During the fourth quarter of 2015, the FDIC published a proposed rule (**Proposed Rule**) that would implement the requirements of Section 334 by imposing a deposit insurance assessment surcharge on insured depository institutions with total consolidated assets of US$10 billion or more (**Large Banks**) and providing assessment credits to Small Banks if the reserve ratio meets 1.40%.

Under the Proposed Rule, Large Banks will be required to pay a surcharge on their normal quarterly deposit insurance assessments beginning in the quarter after the reserve ratio reaches 1.15%. As of September 30 2015, the DIF's reserve ratio was 1.09%, and is expected to reach 1.15% in fourth quarter 2015 or first quarter 2016. The surcharge would be equal to an additional 1.125 basis points per quarter (4.5 basis points annually) on a Large Bank's regular assessments. The FDIC estimates that the additional 4.5 basis point surcharge would raise the DIF reserve ratio to 1.35% within eight quarters (i.e. before the end of 2018). If the reserve ratio does not reach 1.35% by December 31, 2018, the FDIC will impose an additional, one-time shortfall assessment on Large Banks on March 31 2019, to be paid by June 30 2019.

Previously, in February 2011, the FDIC released a final rule adopting a schedule of lower deposit insurance assessment rates that would take effect once the reserve ratio reaches 1.15%. Once the reserve ratio reaches 1.15%, the combined effect of the Proposed Rule and the FDIC's prior rule would be to reduce regular assessment rates overall, while effectively raising rates on Large Banks through the surcharge. To further offset the cost of raising the reserve ratio for Small Banks, the Proposed Rule would establish a system of credits to the Small Banks' quarterly assessments. For each quarter the DIF reserve ratio is at least 1.40%, each Small Bank will receive a credit to its assessment based on the portion of its prior assessments that contributed to raising the reserve ratio from 1.15% to 1.35%. The credit will be applied by reducing a Small Bank's regular assessments by half a basis point per quarter. If a Small Bank's assessment rate were less than two basis points annually the credit would be used to fully offset its assessments, but at no point would an assessment be less than zero.

LARGE INSTITUTION SUPERVISION COORDINATING COMMITTEE RELEASES REVIEW FINDINGS

In 2010, the Federal Reserve formed the Large Institution Supervision Coordinating Committee (**LISCC**) to coordinate its supervision over domestic bank holding companies and foreign banking organisations that pose a systemic risk to US financial stability and nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council (collectively "SIFIs"). The LISCC's Operating Committee ("OC") is responsible for setting supervisory priorities, overseeing the execution of supervisory activities, and vetting the ratings and messages sent to supervised SIFIs. In November 2014, the Federal Reserve announced it would conduct a review to ensure SIFI examinations were consistent, sound and based on all relevant information, with the specific objectives of (a) determining whether LISCC decision-makers received the information needed

to ensure consistent and sound supervisory decisions; and (b) determining whether adequate methods are in place for those decision-makers to be aware of material matters requiring reconciliation of divergent views relating to SIFI supervision. On November 24 2015, the Federal Reserve published a summary report of the review's findings.

With regard to the first objective, the review found that some LISCC supervisory teams employed sound practices, including maintaining examination work papers that were complete, accurate, and well organised, and thoroughly analysing how firm-provided information and meetings with firm management affected a firm's risk profile, ratings, and planning for future supervisory work. The review also identified other supervisory teams with inconsistent practices, such as insufficient or missing documentation in support of particular supervisory determinations.

With regard to the second objective, the review found that the vast majority of supervisory staff interviewed felt empowered to express divergent views, but that neither the Reserve Banks or the LISCC OC had formalised a process for raising and documenting dissenting views. The review produced several recommendations for remedying these inconsistencies, including drafting an LISCC OC Program Manual describing uniform operating and documentation standards, strengthening examiner training with a curriculum specific to SIFI supervision, and adopting policies to encourage divergent views on supervisory matters.

WHAT TO WATCH FOR IN 2016 IN US FINANCIAL REGULATION: IMPORTANT CHANGES TO AML RULES FOR INVESTMENT ADVISERS IN 2016

The Financial Crimes Enforcement Network of the U.S. Department of the Treasury (**FinCEN**) published a proposed rule in August 2015, which scoped certain investment advisers into the definition of "financial institution" and subjected them to certain requirements under the anti-money laundering (**AML**) program and Bank Secrecy Act (**BSA**). The comment period for the proposed rule ended on 2 November 2015, during which time the agency received 31 comments from trade associations, banking and non-banking organisations, credit unions, and individuals, among others.

In the proposed rule**, FinCEN would require investment advisers that are registered or are required to be registered with the Securities and Exchange Commission (SEC) (generally those with US$100 million or more in regulatory assets under management, or those not regulated by a state authority) to maintain AML programs and to file reports of suspicious activity**. FinCEN noted, however, that it may consider expanding the scope in the future to include small and mid-sized advisers because they are also at risk for "abuse by money launderers, terrorist financers, and other illicit actors." By including SEC-regulated investment advisers in the definition of "financial institution" under the BSA at this time, FinCEN would also require these investment advisers to abide by the requirements of the BSA that are generally applicable to financial institutions and allow for coordination between FinCEN and the SEC for application and examination of the requirements. By amending the definition of "financial institution", FinCEN believes that it is closing the door to potential terrorist financers or money launderers who could otherwise be taking advantage of investment advisers' lack of AML programs and/or BSA compliance to gain access to the U.S. financial system.

FinCEN also proposes to delegate its authority over the enforcement of the rule to the SEC, which already regulates the registered investment advisers to whom this rule applies. Under the BSA, regulated institutions are required to monitor and report suspicious activity and comply with Currency Transaction Report (**CTR**) filings, the recordkeeping requirements for certain transmittals of funds over US$3,000, and information sharing requests pursuant to the USA PATRIOT Act. The new requirement for investment advisers to file CTRs replaces the existing Form 8300 for the receipt of cash or negotiable instruments in an amount greater than US$10,000. The risk-based AML requirements that would be applicable to investment advisers include a written AML program, approved by the board of directors or trustees of the investment adviser and made available to FinCEN or the SEC upon request. At this time, FinCEN is not imposing the burdensome customer identification program requirements or certain other requirements of the BSA on investment advisers, but expects to do so in subsequent rulemaking issued jointly with the SEC.

In connection with the proposed rule, FinCEN posed several questions to potential commenters regarding the risk for abuse by money launderers and terrorist financers; whether the rule adequately captures the institutions that are most vulnerable to this risk; whether foreign advisers should also be captured in the definition of "financial institution"; and what the potential burden may be on the regulated institutions. **These and other issues will likely be addressed in the final rule, which will likely be published by FinCEN in 2016. As proposed, investment advisers would have six months from the date on which the rule becomes final to implement and comply with its requirements. We also anticipate further joint rulemakings between SEC and FinCEN in the coming months.**

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RIGHTING FINANCIAL REGULATORY HARMONISATION

As a result of the 2008 economic troubles, many nations have moved to reform financial regulations. DLA Piper experts have worked on many of these related matters all across the world. While that work continues, there is a new urgency for regulators to harmonise such rules and regulations.

The first week of January saw stock markets beaten badly – many having the worst opening weeks in history. Some of that was, at least in part, fuelled by regulatory changes in China. On 8 July 2015, the Chinese Securities Regulatory Commission placed a six-month ban on larger shareholders (those exceeding 5% of a stock) from selling stock. The impact is that well over 75% of shareholders were banned from selling. While the economy of China continued weakening, those shareholders became progressively anxious. Many sought to sell, but were powerless to do so. Then, as smaller investors supposed the prohibition would end in early January, and that potentially upwards of 150 billion yuan (roughly US$25 billion) could be sold, they sought to sell prior to a potentially massive sell-off.

On Monday, 4 January 2016, new circuit breakers (limit ups and downs on how much the market could move) were triggered. Trading was paused, but resumed as the Shanghai Composite Index fell like a stone nearly 7%. On Thursday, 7 January 2016, the 7% threshold was breached and all trading was stopped – only a half hour into the trading day!

The lesson from this is two-fold. Firstly, regulators shouldn't try to influence trading, much less prices. Secondly, regulators should work with other national regulators to harmonise financial regulations to the extent practicable.

Balancing a free market and an authoritarian regulatory approach is a delicate matter, as well as an elusive endeavour. At the same time, there are many other national regulators who have been over much of this before. There are others around the world who have experience that can be helpful in how regulations might be crafted. Many of those lessons have been learned after being burned. Furthermore, the International Organization of Securities Commissions can be helpful in coordinating greater harmonisation efforts.

While national regulators are not required to harmonise with other national regulators, it is becoming increasingly apparent that if such is not done, we will continue to see aberrations in regulatory structures which will have ripple impacts throughout the world.

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SINGAPORE

CUSTOMER DUE DILIGENCE AND KNOW YOUR CLIENT REQUIREMENTS IN SINGAPORE

The Monetary Authority of Singapore (**MAS**) – the country's central bank and regulator of financial institutions (**FIs**) – has been active in recent months in issuing rules and guidance on anti-money laundering (**AML**) and countering the financing of terrorism (**CFT**). On 22 October 2015, MAS issued Guidance on AML and CFT Controls in trade finance and correspondent banking. This was followed by a set of amendment notices on 30 November 2015 directed at certain FIs on the prevention of money laundering and CFT. More recently, on 3 January 2016, a notice came into force, setting out requirements on customer identification and verification for the Central Depository (Pte) Limited (**Depositary**) – a clearing house for the Singapore securities market.

Guidance on AML and CFT Controls in Trade Finance and Correspondent Banking

In October 2015 guidance set out CDD requirements applicable only to banks, merchant banks and finance companies in Singapore that engage in trade finance and correspondent banking activities. They supplement existing CDD requirements under Singapore law. The guidance covers areas such as identifying trade-based financial crime risks and how to implement measures to mitigate such risks. Recommendations include obtaining further information on a transaction, performing due diligence to obtain such information such as details of commercial invoices and transport documents to ensure their validity.

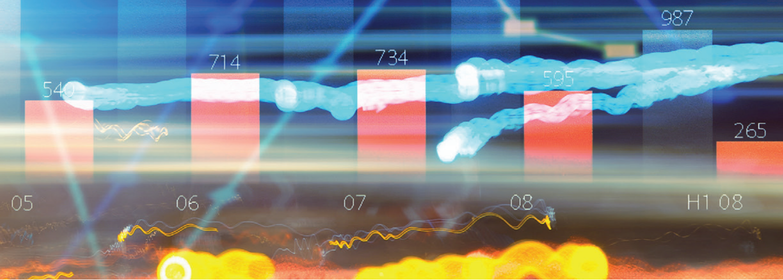
In relation to higher risk correspondent banking activities, banks are advised to identify and perform name screening on beneficial owners, senior management and officers. Further, banks should implement processes to identify "nested" correspondent banking relationships, which include FIs using the bank's direct correspondent relationship with a main FI to conduct transactions and obtain access to other financial services. Banks are also advised to implement ongoing monitoring and periodic due diligence, including reviews of recent transactions (over the last three months) to assess whether the transaction patterns are consistent with the counterparty's profile and projected account activity.

Changes to the Customer Due Diligence (CDD) Requirements for Financial Institutions

Notices are a means by which MAS makes and enforces rules governing financial institutions. The amendment notices issued on 30 November 2015 apply to banks, merchant banks, finance companies, financial advisers and capital markets intermediaries and require the relevant FIs to implement additional CDD measures where they distribute life policies on behalf of a direct life insurer licensed under the Insurance Act. The additional CDD measures are in relation to the beneficiary of a life policy to ensure that the direct life insurer is able to establish the person's identity upon payout. The Notices further reflect that FIs will no longer be exempt from the requirement to enquire if any beneficial owner exists in relation to a government entity customer – either Singaporean or foreign.

Notice on the Prevention of Money Laundering and CFT for the Depository

The 3 January 2016 Notice to the Depositary relates to due diligence on customers and persons associated with them. In addition to the existing measures, the Notice requires the Depositary to implement internal risk management systems, policies, procedures and controls in relation to current and past politically exposed persons, their family members and close associates.



FSB REPORT ON IMPLEMENTATION OF OTC DERIVATIVES MARKET REFORMS

On 4 November 2015, the Financial Stability Board (**FSB**) released two reports on the implementation of reforms to the over-the-counter (**OTC**) derivatives market agreed by the G20.

The *Thematic Peer Review of OTC Derivatives Trade Reporting* assessed progress of FSB member jurisdictions in implementing trade reporting requirements. Whilst comprehensive trade reporting is in place in the majority of FSB member jurisdictions, the report noted that further work is required to ensure data collected by trade repositories can be effectively used by regulators.

The report noted the widespread legal and regulatory barriers to reporting complete transaction information. While mechanisms exist to overcome certain barriers (for example, through obtaining counterparty consent) in other cases barriers cannot be addressed in these ways. FSB members agreed to address remaining legal and regulatory barriers to reporting complete information by June 2018 at the latest. FSB members also agreed that all jurisdictions should have legal frameworks in place to facilitate data access for both domestic and foreign authorities by no later than June 2018. The report further noted several workstreams under the auspices of the Committee on Payments and Market Infrastructures (**CPMI**), FSB and International Organisation of Securities Commissions (**IOSCO**) are underway which, once completed and adopted, are expected to improve the quality and usability of trade repository held data.

The *OTC Derivatives Market Reforms: Tenth Progress Report on Implementation* provided an update on the key developments in OTC derivatives reforms since the previous report published in July 2015. Since July 2015, some additional steps have been taken in a small number of jurisdictions to implement frameworks for promoting central clearing of standardised transactions and for exchange or platform trading of standardised transactions, where appropriate.

The main highlights include:

- 19 of the 24 FSB jurisdictions have trade reporting requirements in force covering over 90% of transactions in their markets. However there remains persistent challenges to the effectiveness of trade reporting, such as authorities' ability to access, use and aggregate trade repository data, that are being addressed through international workstreams;
- 12 out of the 24 FSB jurisdictions have central clearing frameworks in force that apply to over 90% of transactions in their markets, whilst in eight jurisdictions platform trading frameworks are in force that apply to over 90% of transactions;
- Most jurisdictions are in the early phases of implementing the Basel Committee on Banking Supervision/International Organisation of Securities Commissions **(BCBS-IOSCO)** framework for margin requirements for non-centrally cleared derivatives.

The FSB will continue to monitor and report on the OTC derivatives reform implementation progress.

ISDA ANNOUNCES LAUNCH OF NEW INDUSTRY INITIATIVE FOR DERIVATIVES PRODUCT IDENTIFICATION STANDARD IN RESPONSE TO MIFID II

On 17 September 2015, the International Swaps and Derivatives Association, Inc (**ISDA**) announced that it was launching a new industry data project, aimed at developing an open-source standard derivatives product identification system that can be applied consistently and comprehensively across all derivatives facilities, including trading venues, clearing houses, repositories and other infrastructures.

The initiative comes in response to a variety of regulatory changes, including the European Union's revised Markets in Financial Instruments Directive/ Regulation (**MIFID II/MIFIR**) and the US Securities and Exchange Commission's reporting rules, which require a standardised means of identifying derivatives instruments at a granular level. A common methodology for classifying and identifying derivatives instruments across all platforms will cut complexity and costs for market participants that need to connect to multiple trading venues, and simplify the distribution of liquidity.

ISDA is overseeing the 'Symbology Project' which involves a consortium of 18 major buy and sell side market participants, vendors, platforms and trade association. The consortium will initially work to produce globally standardised symbols for credit, rates and equity derivatives. ISDA has created a Symbology Governance Committee which will provide oversight and governance for the clear classification and identification standard that meets both industry and regulatory requirements.

EU CAPITAL MARKETS UNION

In our May 2015 issue of *Exchange – International* we reported on the European Commission's 18 February 2015 green paper titled *Building a Capital Markets Union.* The paper explains the aims of the Capital Markets Union (CMU) to improve and increase access to financing for businesses across Europe, particularly small to medium sized enterprises (SMEs), and investment projects such as infrastructure. The CMU also aims to make markets work more effectively and efficiently, in linking investors to those who need funding. We also reported that the Commission had, on the same date, published a consultation document on its review of the Prospectus Directive, which it considers to be a key feature of establishing the CMU.

On 30 September 2015, the Commission published an action plan on building the CMU (action plan). The main motivation offered by the Commission for driving forward these plans is the amount of funding available to private companies within deep and effective capital markets. The Commission compares the EU to the US in this regard and states that if venture capital markets in the EU were operating at similar levels as those in the US, over €90 billion would have been available to finance companies between 2009 and 2014. The action plan notes that there is no one single measure that will deliver the CMU. Instead there will be a range of steps whose impact will cumulatively be significant. These steps are highlighted below.

Enhancing funding choices for Europe's businesses and SMEs

The Commission notes that barriers exist at every stage of the capital markets fundraising process of Europe's businesses. These barriers are particularly pertinent to SMEs and smaller businesses such as start-ups. To overcome these barriers, the Commission will modernise the Prospectus Directive making it less costly for businesses to raise funds publicly and review regulatory barriers to small firms listing on equity and debt markets. Further, the Commission will launch a package of measures to support venture capital and equity financing, including amending the Regulation on European Venture Capital Funds and the Regulation on European Social Entrepreneurship Fund. Also on 30 September 2015, the Commission published a consultation paper to gather evidence on the performance of these two regulations and identify measures to increase the use of passports for venture capital funds and social entrepreneurship funds. The Commission hopes to promote innovative forms of business financing such as crowd-funding, private placement and loan-originating funds whilst safeguarding investor protecting and financial stability.

Infrastructure financing

The Commission notes that Europe requires new long term and sustainable financing for infrastructure to enhance competitiveness and shift to a low-carbon economy. The Commission will therefore swiftly revise Solvency II calibrations to that insurance companies are subject to a regulatory treatment which better reflects the risk of infrastructure and European Long Term Investment Fund investments. A similar review of the Capital Requirements Regulation for bank exposures to infrastructure will also be undertaken.

The action plan also announced the launching – on the same day – of a call for evidence to evaluate the interactions between rules and the cumulative impact of regulation on investment markets. This, the Commission says, builds on the work of the European Parliament, the Financial Stability Board and the Basel Committee on Banking Supervision in revising the coherence of financial regulation since the global financial crisis.

Retail and institutional investors

The action plan sets out plans to increase investment and choices for retail and institutional investors. The Commission cites that retail investors have significant amounts saved in bank accounts but are engaging less in capital markets. In relation to institutional investors, the Commission determines that they cannot find sufficient investments that deliver the returns needed to meet their commitments.

In response to these issues, the Commission will examine ways to boost choice and competition in cross-border retail financial services against a backdrop of increased on-line provision and fintech. The scope of this would include disproportionate marketing requirements, fees, and other administrative requirements imposed by host countries and the tax environment. The Commission will then seek to eliminate key barriers, through legislative means if necessary.

The Commission will also consider establishing a European market for personal private pensions in which pension providers could opt for when offering private pensions across the EU. The commission will determine whether EU legislation is required to underpin this market. Further, the Commission will deliver an effective European fund passport that eliminates cross-border fees and barriers to increase competition and consumer choice.

Bank lending

In the action plan, the Commission notes the central role of banks as lenders to business, particularly to SMEs. To ensure that bank lending continues to play a central funding role, the Commission will revitalise European securitisations to free up capacity on banks' balance sheets to enhance access to investment opportunities for long term investors. On the same day as the action plan was published, the Commission published a legislative proposal for creating a European framework for simple, transparent and standardised securitisation. Amendments to the Capital Requirements Regulation to make capital treatment of securitisations for banks and investment firms more risk-sensitive are planned for a later stage.

Also on 30 September 2015 the Commission launched a consultation on covered bonds in the EU, with a view to developing a pan-European framework for covered bonds. The Commission cites as its rationale for this the currently fragmented state of the covered bonds market along national lines, and expresses a desire to build on these national regimes without disrupting them.

The action plan also cites the use of credit unions to encourage lending, as they are already exempted from the Capital Requirements Directive regulatory framework in some member states. The Commission believes that this benefit should extend to all member states, and therefore states its intention to explore the possibility for all member states to authorise credit unions which operate outside the capital requirements framework for banks.

Bring down cross-border obstacles to investment

The Commission notes that there are still many obstacles that stand in the way of cross-border investment including inconsistent insolvency, tax and securities laws as well as fragmented market infrastructure.

The Commission will consult on key insolvency barriers and take forward a legislative initiative on business insolvency, including early restructuring and second chance. The Commission also plans to address uncertainty surrounding securities ownership, by proposing uniform rules to determine which national law shall apply to third party effects of the assignment of claims. The Commission vows to undertake a review on removing Giovannini barriers (specific barriers identified by the Giovannini Group of banking experts that prevent efficient EU cross-border clearing and settlement), following the implementation of recent legislation and market infrastructure developments. Further, the Commission also plans on addressing tax obstacles to cross-border investment by, for example, promoting best practice and developing a code of conduct with member states on withholding tax relief principles.

An area pertinent to cross-border investment identified by the Commission in its action plan is financial stability. It therefore proposes to work with the Financial Stability Board and European Supervisory Authorities alongside the European Systemic Risk Board to assess possible risks to financial stability arising from market-based finance. The Commission states that it will work with European Securities and Market Authority (**ESMA**) to develop and implement a strategy to strengthen supervisory convergence and to identify areas where a more integrated approach can improve the functioning of the single market for capital. Finally the Commission will, through the Structural Reform Support Service, develop a strategy for providing technical assistance to member states where needed to reinforce specific capacities of national capital markets.

Next steps

The action paper outlines that the proposed actions will be subject to consultation and impact assessment. However the Commission had previously stated in a February 2015 green paper that by 2019 it intends to have completed the priority actions to have the CMU in place.

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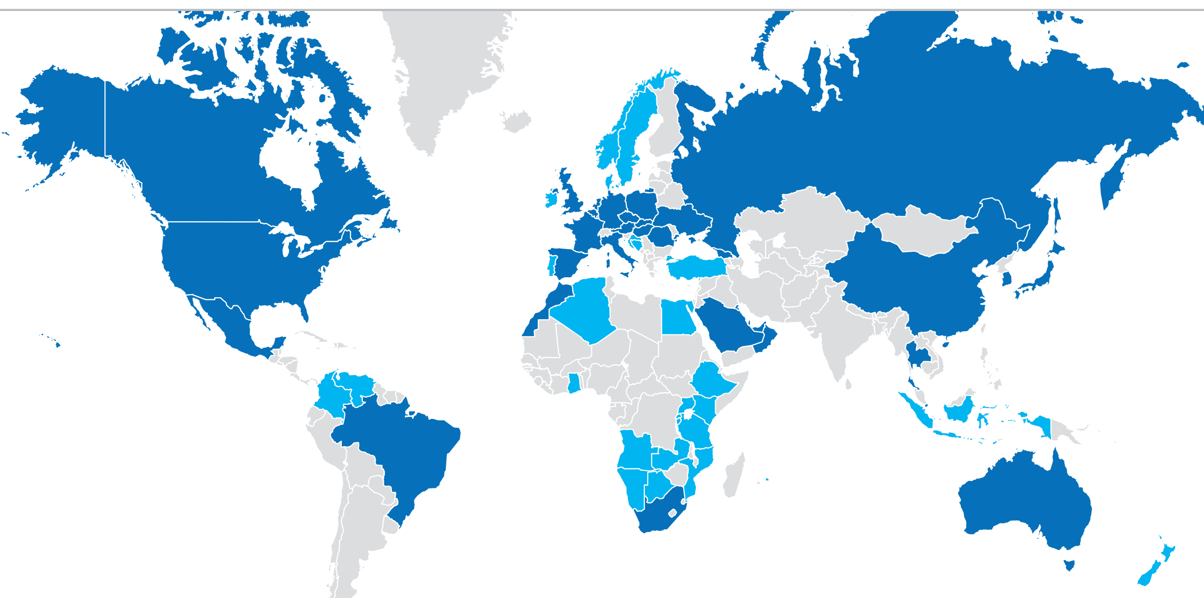

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