DUFF & PHELPS

REGULATORY FOCUS

A synopsis of the Financial Conduct Authority's (FCA) latest news and publications issued in October 2016.

ISSUE 100

A New Regulatory Capital Regime for Investment Firms

CRDIV ushered in a requirement for the EU Commission to recommend whether CRDIV was an appropriate prudential regime for MiFID investment firms. There has always been a view that CRDIV (and its predecessors) is designed for banks (as it is the EU's method of implementing Basel Accords) and not a proportionate or effective regime for investment firms. In December 2015, the EU Commission recommended that a more appropriate prudential regime for investment firms should be considered and an indicative timetable towards achieving this was mapped out.

The latest situation is that the European Banking Authority (EBA), the European Supervisory Authority (ESA) leading what is now known as the 'Investment Firm Review', has issued a request for information to assist it to devise various workable alternative regimes. A Discussion Paper on the Investment Firm Review was published on 4 November 2016 and this will be followed by a formal Consultation Paper in which the proposed new regime will be laid out.

Although the formal data collection date was 7 October 2016, we understand from the FCA that it would welcome late submissions. It is in the best interests of MiFID investment firms (including AIFM and UCITS collective portfolio management investment firms) to provide information and a lack of statistically significant data could easily lead to disproportionate outcomes.

We strongly encourage firms, particularly small firms, to submit data using the EBA templates. These should be sent to the FCA at this address as soon as possible, in order to positively influence the outcome of an appropriate regime. Please note that firms have been advised that data will be anonymised and will not be used by the FCA for any other purpose.

Enforcement Actions

FCA Fines Insurance Firm £8.2m for Client Money and Assets Failings

5 October 2016

The FCA has fined a UK based insurance and pension provider £8,246,800 for failings relating to the protection of client assets and oversight of its outsourced providers. It was found that the Firm breached Principles 3: Adequate Systems, Management and Controls, and Principle 10: Safeguarding Client Assets, between 1 January 2013 and 2 September 2015. This is the first CASS enforcement action in relation to oversight of outsourcing arrangements. The FCA stressed in its press release that even with outsourced arrangements firms are still responsible for compliance with CASS rules, reminding them that "regulated activities can be delegated not abdicated".

During the period, the Firm had outsourced the administration of client money and external reconciliations in relation to custody assets. Despite this outsourcing of significant functions, the Firm failed to put in place appropriate controls over its third party administrators. As a result, the Firm did not challenge the internal controls, competence and resources of the third party administrators to a sufficient degree. Furthermore, the Firm failed to dedicate adequate resources and technical expertise to assist in the implementation of effective CASS oversight arrangements, resulting in delayed detection and rectification of CASS risks and other compliance issues.

The FCA also found that failings in the firms internal reconciliation process led to the under and over- segregation of client money. From 10 February 2014 to 9 February 2015 under-segregation reached a maximum value of £74.4 million. These failings also meant that the Firm was unable to meet its obligations to submit accurate Client Money and Asset Returns (CMAR) and maintain an adequate CASS resolution pack.

The FCA considers these failings particularly serious as CASS Rule breaches had been identified in annual external CASS reports for consecutive years. Although, there was no actual loss of client money or assets, these rules are designed for the purpose of being preventative and customers may have suffered losses had the Firm become insolvent during the period.

The Firm agreed to settle with the FCA in the early stages of the Investigation and therefore the penalty was reduced from £11,781,262 to £8,246,800. This case demonstrates the FCA's determination to investigate all instances of non-compliance, even when the customers have not directly suffered financial losses.

The FCA's press release can be found here.

FCA Imposes Penalties on a Bank and its Former Money Laundering Reporting Officer for Serious Anti-Money Laundering Systems Failings

12 October 2016

The FCA has fined a bank £3,250,600 and its former MLRO £17,900 for money laundering failures. In addition, it has restricted the Firm from accepting deposits for 168 days and prohibited the MLRO from performing the MLRO or compliance oversight functions at regulated firms.

Between 20 August 2010 and 21 July 2014, the FCA found that the Firm had failed to maintain adequate AML systems despite having received previous warnings from the FCA. The Regulator found that the Firm had failed to comply with its obligations in respect of customer due diligence, its approach to politically exposed persons and the making of suspicious activity reports. In addition to failings in relation to the AML policies and procedures, the FCA also found serious and systematic weaknesses with the Firm's senior management team, its money laundering reporting function and the oversight of its branches. The Firm was also found to have breached Principle 11 with regards to failing to communicate with the FCA in an open and cooperative manner when it failed to notify the FCA of an allegation of significant fraud.

Mark Steward, Director of Enforcement and Market Oversight at the FCA, stated that:

"Fighting money laundering is an issue of extreme international importance and ensuring that AML controls are effective and viewed as important throughout the business are fundamental obligations of all regulated firms."

"There is an abundance of guidance for firms on how to comply with AML and financial crime requirements and no excuse for failing to follow it. The FCA will not hesitate to take action against firms and senior individuals who fall short of our standards. As in this case, such action may include using our powers to restrict a firm's continuing business."

The FCA found that the Firm's Money Laundering Reporting Officer failed to ensure the effectiveness of the Firm's AML systems and controls despite receiving repeated warnings from the banks internal auditors. The FCA did consider the fact that the individual was overworked and lacked support from senior management but concluded that the failings of the individual were serious enough in their own right to warrant action.

The FCA stated that the individual could have taken steps to ensure that the appropriate controls were in place, such as escalating concerns internally, but instead the individual reassured the board and senior management that the controls were working well and failed to report concerns of the Firm's internal auditors appropriately. The FCA also pointed out that it was in the MLRO's power to express to senior management the need for more resources. The individual also failed to produce appropriate annual MLRO reports and failed to report concerns to the FCA which could have been made on a confidential basis. By failing to take any of the above steps the FCA found that the individual had "failed to exercise due skill, care and diligence in managing the business of the Firm for which he was responsible, and that he was knowingly concerned in aspects of the Firm's breach of Principle 3.

The full press release can be found here.

The FCA Bans Two Individuals from Participating in Any Regulated Activity

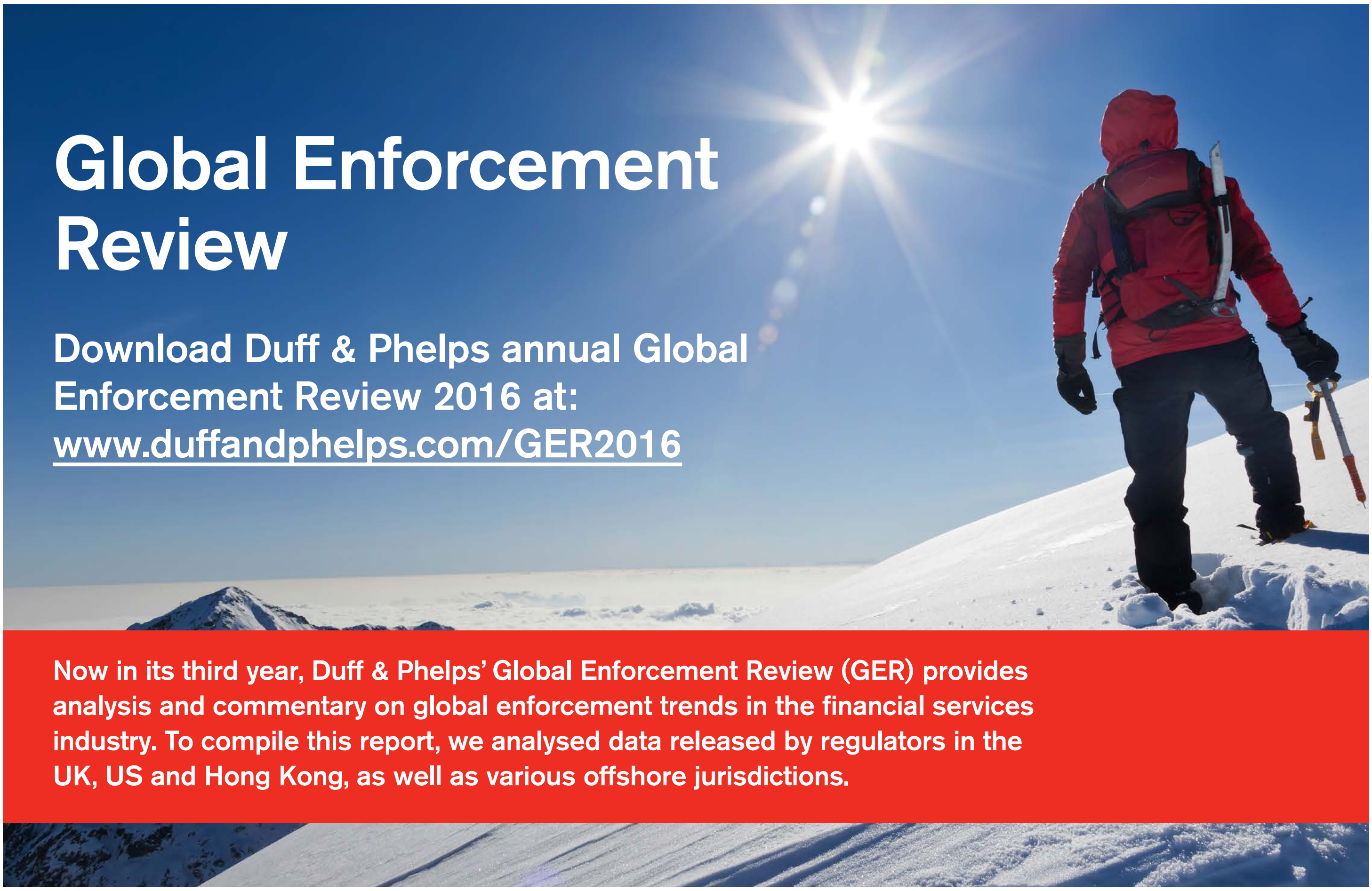
25 October 2016

The FCA has taken action against two individuals by concluding that each were not fit and proper to carry out any function in relation to any regulated activities. As a result, both were prohibited from participating in any regulated activity within the financial services industry.

This followed each being charged for dishonesty offences by the Serious Fraud Office and Nottinghamshire Police in November 2013, relating to investments made in relation to a Firm through its Administrators. The Firm was an unregulated property investment vehicle that lost approximately £45 million of investors' money before entering liquidation in February 2012. Claims for compensation relating to this, including the activities of the financial advisers involved, are now being considered. In July 2014, the first individual was sentenced to 10 years and 10 months' imprisonment having pleaded guilty to three counts of fraud. The second individual pleaded guilty to two counts of forgery and three counts of fraud and was sentenced to two years' imprisonment, suspended for two years.

Further to this, the FCA suspended the Administrator's regulated activities.

Further detail can be found on the FCA website here.



Supervision Matters

FCA Publishes Proposals on Transactions Cost Disclosure

5 October 2016

Consultation Paper 16/30 proposes rules and guidance to improve the disclosure of transaction costs in workplace pensions. It sets out standards to enable independent governance committees (IGCs) and trustees to obtain a standardised disclosure of the transaction costs that pension investments incur.

Under the current rules, asset managers are not required to provide a full disclosure of transaction costs in a standard form. Instead independent governance committees of pension funds request and report on these costs as they are able. The FCA is proposing that a duty be placed on asset managers to disclose aggregate transaction costs to pension schemes that invest in their funds, directly or indirectly. The proposal also states that asset managers provide the breakdown of transaction costs on request. The total of transaction costs would be disclosed and the amount of specifically identifiable costs such as taxes and securities lending costs would also be detailed.

The proposed new rules are intended to bring a new level of consistency to the manner in which transaction costs are reported. This would in turn give governance bodies increased confidence in the information presented to them. The FCA is also proposing a calculation methodology for evaluating transaction costs, called the slippage cost. The slippage cost will compare the price at which a transaction was executed to the price when the order to transact entered the market.

Firms that are unable to provide transaction cost information will need to provide the governance body with a clear explanation as to why it was not possible to provide the information. The consultation is open until 4 January 2017.

The FCA's press release can be found here.

Speech: Culture in UK Banking – Regulatory Priorities

18 October 2016

The Chief Economist of the FCA, Peter Andrews, has considered how regulators might improve conduct in banking during a speech to the Westminster Business Forum. Two themes which occurred throughout the speech were that of good culture and accountability.

Mr. Andrews highlighted how the FCA's upcoming paper entitled 'Behaviour and Compliance in Organisations' focuses on how combining insights from behavioural economics, sociology and psychology with traditional economic thinking can assist regulators to improve compliance with the rule book. He outlined some of the observations from the upcoming paper including one idea to direct penalties at the individuals who are personally more responsible for the wrongdoing as opposed to the Firm. By making the risks more 'personal' this is likely to act as a deterrent to non-compliance.

Mr. Andrews discussed the beneficial impact of regular relevant communications to employees about penalty actions issued against other firms within the market. This could result in strong discouraging messages from the senior manager of a firm to all staff. Mr. Andrews also discussed morality. By emphasising to staff the impact that certain products and decisions can have on the lives of their customers, staff may in turn be more likely to act in the best interests of their customers.

Mr. Andrews also considered whether firms could create accountability structures where there is as little diffusion of responsibility as possible. He concluded it is clear that accountability has a role to play with regards to ensuring compliance with the rule book and that the Senior Managers Regime is a further step in this direction and will play a strong role in creating more accountability going forward.

The complete speech can be found here.

The FCA's Mission

26 October 2016

The FCA has sought the participation of its stakeholders as it prepares to revise its Mission in a new consultation paper. The Mission aims to provide the FCA with a clearly articulated framework for what it does and the aim is for such a framework to 'improve accountability and transparency.' It is intended that this will give participants within the financial services industry a clearer understanding of how and why the FCA makes its decisions.

The FCA's objectives stem from Parliamentary legislation and the Mission does not aim to overrule any existing objectives, but rather to sharpen the Regulator's focus. In doing so, the FCA's purpose is to create what it has termed a 'framework for conduct regulation' that will focus on but is not limited to the following areas:

- **Protecting consumers:** The FCA will seek to find a balance which will enable firms to be competitive whilst preserving the best interest of consumers. The FCA will consult on the right level of consumer protection.
- **Vulnerable consumers:** Whilst protection is currently being afforded to 'vulnerable consumers', the Mission will see the FCA offer greater clarity about who is deemed a 'vulnerable consumer'.
- **Delivering consumer redress:** The FCA seeks to address what its role should be in redress situations, particularly for those complaints which are currently outside of its remit.
- **When the FCA intervenes:** The Mission will aim to improve how the FCA identifies anything untoward and the intervention methodology deployed.
- **The scope of regulation:** The FCA will clarify the unregulated areas where it has authority to take action and perhaps intervene.
- **FCA Handbook:** The Regulator is seeking feedback on how it can better improve the FCA handbook.

Full details can be found on the FCA's website here.

If you would like to participate in the FCA's survey, the link to the form to complete can be found here.

New Derivatives Report for EEA UCITS Managers

(12/12/2016 deadline)

UK authorised fund managers or UK management companies of an EEA UCITS scheme will have to complete a new return to the FCA providing data on the use of derivatives in UCITS schemes. The new report is a revision of FSA042 and is referred to as the 'Derivative Use Report' (DUR) and replaces the Derivative Risk Management Process (DRMP) report.

In summary, the FSA042 has been revised in order to include the information required by FCA Rule COLL 6.12.3AR on derivatives/ risk management process. This report needs to be submitted annually within 30 business days of 31 October, with information accurate as at 31 October that year. There is a deadline of 12 December 2016 for the first DUR submission, which should be made via GABRIEL.

The FCA has updated the FAQ's available on its website and these are fairly extensive, covering the definitions of symbols used on the return and special instructions on how to complete the form. The FCA has flagged the requirements in October's 'Regulation round-up' and states that GABRIEL will be available to receive submissions from 21 November 2016.

Background

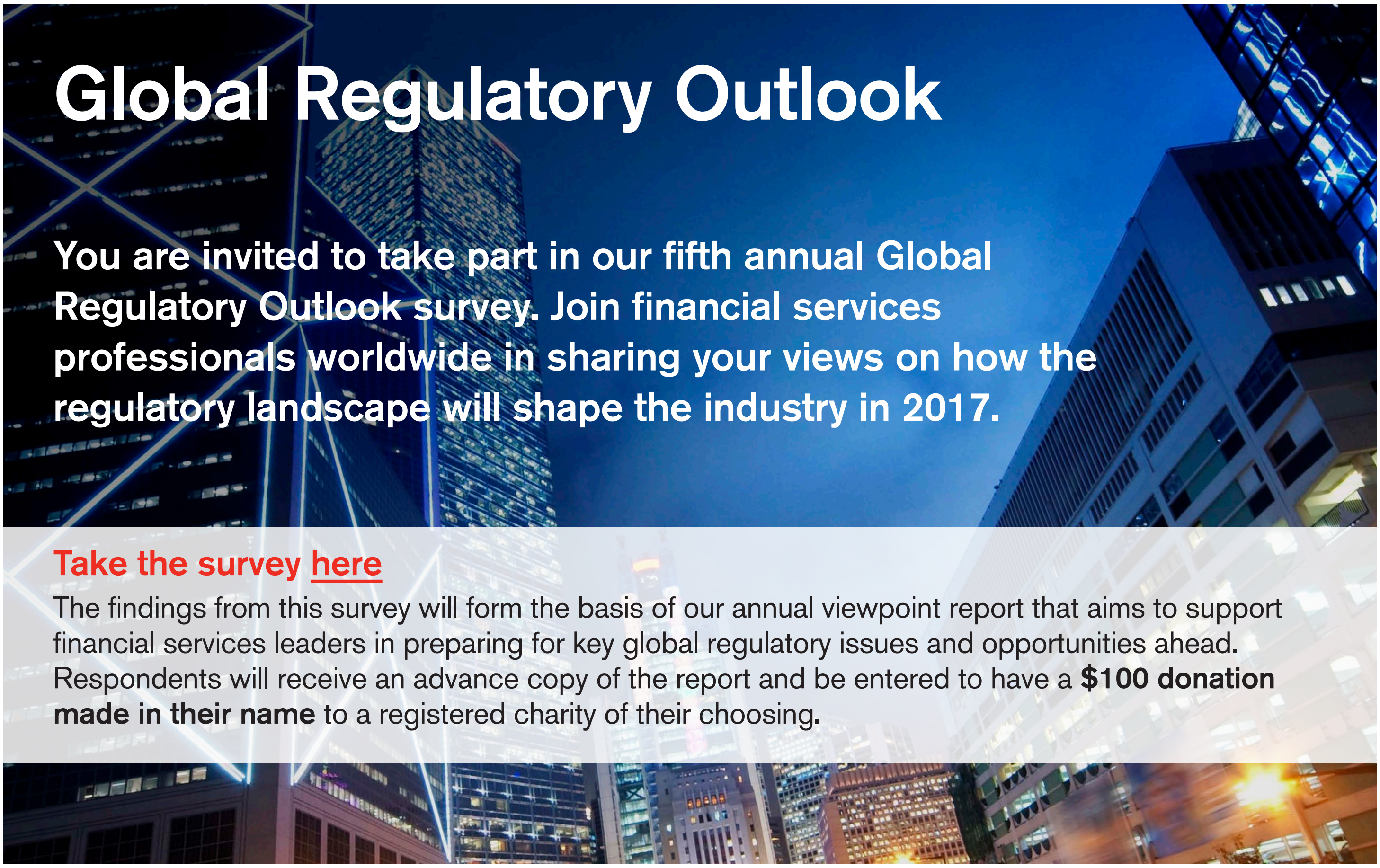
The FCA published comments last year on its website regarding submission of DRMP reports, as a review highlighted that these reports were not being submitted by the majority of firms despite being an annual requirement.

Unsurprisingly the FCA has decided to address the issue further. The proposed change was outlined in Consultation Paper (CP) 15/27 covering UCITS V changes and confirmed in Handbook Notice 35. The CP notes that the DRMP format was not defined, and information was often 'incomplete or in a format that is not easy to assess or compare'. Requiring firms to submit the return via GABRIEL means that it will appear on firms' schedules of returns and will assist firms to submit in a timely fashion.

The FCA have suggested that for most firms this new requirement will simply 'formalise' information which is currently submitted and would be available as part of ongoing risk management and calculation of the NAV.

Please note that firms that have already submitted information for this reporting period (i.e. a DRMP return in the last 12 months) will still have to submit the new return by the deadline of 12 December. Where there is a significant change to the funds risk profile firms are still required to send the new form to notify the FCA (via e-mail not GABRIEL). There is some guidance on what constitutes a significant change within COLL 6.12.3B to assist firms in making this determination.

Links to the relevant Consultation and Handbook Notice can be found here and here respectively.



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