FINANCIAL SERVICES REGULATION
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DLA PIPER

CONTENTS

INTRODUCTION	04
EUROPEAN UNION	05
UNITED KINGDOM	13
USA	26
NORWAY	33
SPAIN	34
AUSTRALIA	38
INTERNATIONAL	40
IN FOCUS	42
CONTACTS	44

INTRODUCTION

WELCOME

DLA Piper's Financial Services International Regulatory team welcomes you to the thirtieth edition of 'Exchange – International' – our 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, NORWAY, SPAIN and AUSTRALIA.

In this edition, "In Focus" looks at the FSB's Progress Report to the G20 on its action plan assessing and addressing the decline in correspondent banking.

In addition, we look at the EU Council Progress Report on the EDIS Regulation; the FCA Responsible Lending Thematic Review; and the New York DFS final rule against money laundering and sanctions violations.

Your feedback is important to us. If you have any comments or suggestions for future issues, we welcome your feedback.

EUROPEAN UNION

EUROPEAN COMMISSION CONSULTS ON CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

On 2 June 2016, the European Commission (**EC**) issued a consultation paper on the main obstacles to cross-border distribution of investment funds.

The consultation is part of the EC's September 2015 Action Plan to create a Capital Markets Union and aims to identify and address remaining obstacles in the way of promoting cross-border investment in funds both in retail and wholesale markets. The underlying purpose of the Capital Markets Union is to establish a single market for capital, in order to mobilise capital in Europe and channel it to companies, particularly SMEs, and infrastructure projects. The EC acknowledges that funds can have an important role in achieving this aim, by effectively and efficiently allocating capital across the EU.

Overall, 57% of funds (both Undertakings for Collective Investment in Transferable Securities (**UCITS**) and alternative investment funds (**AIFs**)) are marketed on a cross-border basis. However, despite the growth of investment fund markets and the regulatory progress achieved to date, the EC considers that more can be done to deepen the single market for funds. The costs of marketing across borders may fall disproportionately on smaller, start-up or more specialised funds. Other potential barriers to cross-border distribution identified include the impact of concentrated funds distribution channels in individual member states, cultural preferences for funds managed in investors' home states and a lack of incentives for managers to compete on a cross-border basis. The EC has noted that one of the obstacles constantly cited are the regulatory barriers to distribution. Burdensome registration procedures, costly and diverse marketing requirements, inconsistent administrative arrangements and tax obstacles were identified in response to the Capital Markets Union Green Paper and to the Call for Evidence on the EU Regulatory Framework for Financial Services. The EC considers that eliminating unjustified barriers would enable fund managers to engage in more cross-border selling of funds, increasing competition for the benefit of investors.

In order to assess how cross-border distribution of funds could be improved, the EC is requesting input from stakeholders and distributors. The consultation seeks feedback on marketing restrictions, distribution costs and regulatory fees, administrative arrangements, distribution networks, notification processes and taxation.

It is noteworthy that the EC has excluded from its consultation questions regarding the marketing of non-EU AIFs in the EU or marketing by non-EU AIF managers in the EU. This is presumably because the Alternative Investment Fund Managers Directive (**AIFMD**) contains provisions for an EU passport to be introduced eventually in respect of such marketing, which has yet to be brought into effect. Such marketing is currently subject to the National Private Placement Regime (**NPPR**) of each member state, the minimum requirements for which are set out in the AIFMD. Although the NPPRs are temporary measures, non-EU fund managers and EU fund managers of non-EU funds who have attempted marketing across numerous member states will be well aware of the significant differences between the NPPRs of certain member states, which significantly adds to the costs of marketing in the EU.

The EC consultation closes on 2 October 2016.

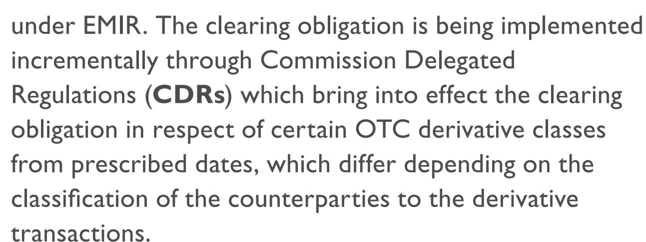
In parallel to the consultation, and following a call from the Economic and Financial Affairs Council, which is made up of the economics and finance ministers from all member states, the EC has introduced a member states Expert Group on barriers to free movement of capital, which will aim to map national barriers, identify the most damaging obstacles to the internal market and find the most efficient ways to remove them.

ESMA CONSULTS ON DELAYING EMIR CLEARING OBLIGATION FOR CERTAIN COUNTERPARTIES BY TWO YEARS

The European Securities and Markets Authority (**ESMA**) published a consultation paper on 13 July 2016, which sought the views of stakeholders on a proposal to amend the phase-in period of the clearing obligation for "Category 3" counterparties as established under the European Market Infrastructure Regulation (Regulation (EU) No 648/2012) (**EMIR**). The consultation period closed on 5 September 2016.

Introduction of the clearing obligation

EMIR introduced an obligation to clear over-the-counter (**OTC**) derivatives through central counterparties (**CCPs**) that have been authorised to act or recognised



under EMIR. The clearing obligation is being implemented incrementally through Commission Delegated Regulations (**CDRs**) which bring into effect the clearing obligation in respect of certain OTC derivative classes from prescribed dates, which differ depending on the classification of the counterparties to the derivative transactions.

ESMA proposed to delay the date of the clearing obligation in respect of Category 3 counterparties, both in respect of the two such existing CDRs and one expected upcoming CDR.

Category 3 counterparties

Category 3 counterparties are financial counterparties, or alternative investment funds which are classified as non-financial counterparties, and which belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives across a defined three-month period (which differs between each CDR) is below €8 billion. Categorisation of counterparties is therefore based on a quantitative threshold. ESMA estimated that these counterparties represent 5.1% of the volume of activity in the market and 93.5% of the number of counterparties.

Proposal to modify the phase-in period for Category 3 counterparties

ESMA identified in the consultation paper that certain counterparties were struggling to access CCP clearing, particularly smaller counterparties such as those falling within Category 3. ESMA stated that, due to the cost, risk and legal issues associated with accessing a CCP as a clearing member, it is not feasible for Category 3 counterparties to access CCPs by becoming clearing members. Therefore, such counterparties must either become clients of clearing members, or establish indirect clearing arrangements.

ESMA identified that clearing members have little appetite for providing client clearing services to smaller companies. It also identified that indirect clearing arrangements are not established in this market to the same extent as in the exchange traded derivatives market, further preventing Category 3 counterparties from being able to comply with their clearing obligations.

Therefore, as part of the consultation, ESMA proposed the implementation of a longer phase-in period for Category 3 counterparties. The objective of the proposal is to provide Category 3 counterparties with additional time to comply with the clearing obligation without compromising the overall objective of the clearing obligation, which is the reduction of systemic risk. However, ESMA also sought to further identify and quantify the difficulties that Category 3 counterparties are facing in preparing for the central clearing obligation in order to determine whether further action is needed to address this problem.

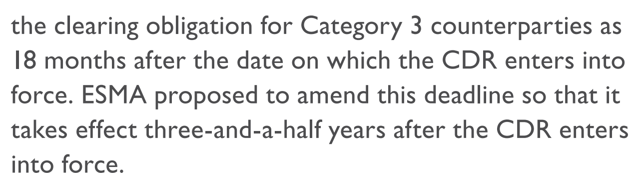
ESMA acknowledged that the estimated period of time which Category 3 counterparties should take to establish clearing arrangements may have been underestimated. ESMA indicated that the phase-in period for Category 3 counterparties should take into account the following regulatory developments: the draft Regulatory Technical Standards on indirect clearing arrangements (which are expected to increase the availability of indirect access to CCPs, but have not yet been adopted); and the finalisation of the leveraged ratio framework globally, and how this will be taken into account in the EU under the Capital Requirements Regulation (which may have an impact on the appetite of clearing members to provide client clearing).

Accordingly, ESMA proposed in the consultation paper to modify the date of application of the clearing obligation to Category 3 counterparties. It asked various questions to obtain relevant feedback on its proposal and associated issues.

Current status of the clearing obligation and proposed delay

The first CDR, which covers certain interest-rate derivatives in USD, EUR, GBP and JPY, sets the compliance deadline for the clearing obligation for Category 3 counterparties as 21 June 2017. The second CDR, which covers certain European index credit default swaps, sets the compliance deadline for the clearing obligation for Category 3 counterparties as 9 February 2018. ESMA proposed to amend these dates to 21 July 2019 and 9 February 2020 respectively.

The expected third CDR, which will cover certain interest-rate derivatives in NOK, PLN and SEK, as currently drafted, would set the compliance deadline for



the clearing obligation for Category 3 counterparties as 18 months after the date on which the CDR enters into force. ESMA proposed to amend this deadline so that it takes effect three-and-a-half years after the CDR enters into force.

Next steps

ESMA indicated that it will consult the European Systemic Risk Board and the competent authorities of third-countries, where relevant, when developing technical standards on the clearing obligation.

After analysing the feedback received, ESMA noted that it expects to publish its final report, including draft technical standards, in Q4 2016 to be endorsed by the European Commission.

ESMA FINES FITCH RATINGS €1,380,000 FOR SOVEREIGN RATING PROCESS FAILURES

On 21 July 2016, the Board of Supervisors of the European Securities and Markets Authority (**ESMA Board**) issued a decision to impose fines amounting to a total amount of €1,380,000 and issued a public notice as a supervisory measure in respect of negligent breaches by Fitch Ratings Ltd (**Fitch**) pursuant to the Credit Rating Agencies Regulation ((EC) No 1060/2009) (**CRA Regulation**). ESMA identified the relevant breaches after a review of the sovereign rating processes of a number of Credit Rating Agencies (**CRAs**) was undertaken from 1 September 2010 to 25 February 2013.

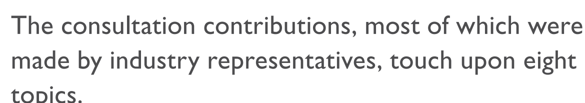
ESMA reported three breaches by Fitch:

1. **Failure to satisfy the 12 hour requirement:** CRAs are obliged to inform the rated entity of its upcoming rating and the principal grounds the rating is based on. Having notified Slovenian representatives of the intention to downgrade it on 26 January 2012, Fitch only informed them of the relevant grounds on 27 January 2012, three hours prior to the public announcement. Fitch was found to have negligently infringed its relevant commitments specified in Annex III, Section III, point 7 of the CRA Regulation and a fine of €60,000 was imposed.
2. **Lack of proper internal controls to comply with the 12 hour requirement:** Between 1 June 2011 and 14 February 2012, the ESMA Board held that Fitch did not provide clear guidance to its staff, the internal control function did not detect the absence of control, the follow-up action did not detect or address the shortcomings and those responsible did not exercise their control functions correctly. Fitch was found to have negligently infringed its relevant commitments specified in Annex III, Section I, point 12 of the CRA Regulation for more than six months and a fine of €852,000 was imposed. It should be noted that since 20 June 2013, with the introduction of Regulation (EU) 462/2013 on CRAs, the time requirement has been extended from 12 hours to a full working day.
3. **Unauthorised disclosure of information:** Although CRAs are prohibited under the CRA Regulation from disclosing information regarding upcoming ratings to persons not involved in the rating, from 1 December 2010 to 7 June 2012 certain Fitch senior analysts transmitted information to certain senior persons in Fimalac S.A. (the ultimate parent company of Fitch), before that information had been made public. ESMA found a breach only with regard to the time between 1 June 2011 to 7 June 2012, yet nine separate email exchanges were identified regarding actual or potentially upcoming rating actions for the entire period concerned. Fitch was found to have negligently infringed its relevant commitments specified at Annex III, Section I, point 34 of the CRA Regulation for more than six months and a fine of the amount of €495,000 was imposed.

Fitch has voluntarily taken measures to prevent similar infringements in the future and this was taken into consideration when the fine was imposed. Fitch has the ability to appeal this decision.

EUROPEAN COMMISSION FEEDBACK STATEMENT AND SUMMARY OF RESPONSES TO CONSULTATION ON CRD IV REMUNERATION REQUIREMENTS

On 28 July 2016, the European Commission (**EC**) issued a feedback statement summarising the responses received from its consultation on the remuneration rules under the Capital Requirements Directive (2013/36/EU) (**CRV IV**). The consultation focused on the impact of the maximum ratio (**MR**) between variable and fixed remuneration, competitiveness, financial stability and staff in non-EEA countries, as well as the efficiency of the CRD IV in general.



The consultation contributions, most of which were made by industry representatives, touch upon eight topics.

MR between the variable and the fixed component of remuneration

Due to the short period for which the MR rule has been in place, the EC recognises that an appropriate assessment of the effectiveness of the MR is not yet possible. However, potential future consequences have been identified. The potential effect on competitiveness is associated with staff recruitment, more specifically skilled individuals rejecting CRD-regulated industries. Many respondents reported being pushed to increase fixed pay in order to remain attractive to their prospective employees. It was noted that this may negatively affect both profitability and the ability of such firms to invest elsewhere. Many respondents also claimed that the MR rule could lead to an increase in the percentage of the fixed component of remuneration that may not be aligned with incentives with the interests of the firm and society, or might not be determined on a risk-adjusted performance basis. New solutions, such as the possibility of downward adjustment of fixed pay, were suggested by several respondents. Many reported that the turnover of staff in non-EEA locations has increased, yet this trend was not clearly identified as being attributable to remuneration rules. There was no overall unanimity in the responses concerning the MR rule's ability to achieve an appropriate balance between the variable and the fixed component of remuneration. However, many respondents thought the MR rule to be too rigid and other remuneration rules to be more efficient in reducing the level of variable remuneration component instead.

Performance assessment

The relevant performance assessment requirements were generally positively received, with the respondents recognising the merits of combining individual and collective assessment and also using both financial and non-financial performance criteria.

Requirement to defer part of the variable remuneration

The requirement to defer part of variable remuneration was also positively received, as respondents considered it useful for achieving long-term performance and deterring excessive risk taking. Flexibility was identified as important for the application of the rules, along with the implementation of relevant exemptions. Most of the respondents argued for the proportionate application of the deferral requirement.

The requirement to pay out part of the variable remuneration in instruments

The majority of the respondents asked for a more proportional application of the requirement to pay out part of the variable remuneration in instruments, claiming that the administrative burden outweighs its benefits in cases where staff earn only low levels of variable remuneration and where institutions are of a small, non-complex or certain legal form that prevents them from issuing such instruments. It was suggested by respondents that both flexibility and efficiency needed to be preserved when determining the types of instruments used.

Malus and clawback

Both malus and clawback (and especially malus) were perceived by respondents as efficient tools against excessive risk-taking and useful for associating remuneration with performance and incentivising individuals' behaviour. Malus refers to the forfeiture of money or shares before these are paid to the individual, while clawback refers to the reimbursement of money or shares that have already been paid or transferred. Clawback was seen as more unusual and harder to apply in practice. Many of the respondents stated that clawback was not allowed under national law and that it could potentially lead to an uneven EU playing field. Others argued that, even when clawback was permitted, its application might be inconvenient depending on the financial capacity of the individual to reimburse the net or gross amount. Malus was, consequently, considered by many of the respondents to be the preferred ex-post instrument.

Requirement for significant institutions to set up remuneration and risk committees

This requirement was mostly perceived by respondents as a positive development, although certain respondents suggested that the CRD IV provisions are not sufficient on their own to deal with misconduct.

Disclosure requirements

The disclosure requirements were positively received on the whole and respondents generally acknowledged that they led to increased transparency. Issues of data protection and confidentiality were, however, raised as potential concerns in cases where the identification of high-earners could be established easily.

Identification of material risk takers

Respondents claimed that the number of identified staff has increased. It was suggested that some of the qualitative criteria defined in the Regulatory Technical Standards (**RTSs**) on Identified Staff needed to be interpreted more flexibly, while there should also be an overall simplification of the qualitative tests of the RTSs. As far as the quantitative criteria are concerned, it was argued that pay was not the only indication of risk-taking and reference was made to the material impact of exchange rate movements to quantitative thresholds.

EC report and the next procedural steps

On the same date as the publication of the feedback statement, the EC, as required by Article 161(2) of the CRD IV, also issued a report with its own assessment on the CRD IV remuneration rules. It concluded that the remuneration rules were generally effective in curbing excessive risk-taking and aligning remuneration with performance towards enhanced financial stability. However, in certain cases, the application of some of the rules appeared to be more costly and burdensome than beneficial and, therefore, an impact assessment will be conducted by the EC to provide further clarification. As to the MR between variable and fixed remuneration, the EC stated that it was too early to fully evaluate the impact of the MR and conclusive findings would be reached once there was more implementation experience. The EC indicated that next steps in the review process include a fact-finding stakeholder event in December 2016 and engagement with member state representatives and supervisory authorities.

EU COMMISSION ADOPTS DELEGATED REGULATION ON ORGANISATIONAL REQUIREMENTS FOR HIGH FREQUENCY TRADERS

On 22 August 2016, the European Commission published a Delegated Regulation (with the Annexes in a separate document) on the organisational requirements for high frequency traders (**HFT**). Requirements on firms who provide direct electronic access (**DEA**) and those who act as clearing members are also included.

The requirements will apply from 3 January 2018 assuming the Council of the EU and the European Parliament do not object.

The Delegated Regulation is based on ESMA's draft RTS 6. Please refer to our previous publication *'Microstructural issues under MiFID II'* for our analysis on the draft RTS.

The Delegated Regulation contains the same **general organisation requirements** as those set out in RTS 6 (which existing MiFID firms should be familiar with), including the following requirements:

- compliance staff need to have access to the "kill functionality";
- compliance staff need to have a general understanding of how algorithmic trading and platforms work and have continuous contact with those who have expertise in the area;
- staff responsible for risk and compliance must have sufficient authority to challenge staff where necessary; and
- compliance must employ a sufficient number of staff with the necessary skill and knowledge in high-frequency trading systems (either present at time of recruitment or acquired after training and kept up-to-date).

The Delegated Regulation makes it clear that the testing requirements apply to algorithms that lead to order execution (whether or not there is limited human intervention). Otherwise the testing requirements remain the same as those set out in the draft RTS, which required:

- sign-off by a "responsible party" (designated by senior management) of the deployment or substantial update (and consequent deployment) of the algorithmic trading system or strategy;
- conformance testing to verify that the HFT's trading system communicates and interacts properly with the trading systems of the trading venue/DEA and that market data is processed correctly;
- the testing environment to be separate to its product environment – HFTs will be able to choose to use their own testing environment or a testing environment provided by a trading venue, a DEA provider or a vendor;
- controlled deployment of algorithms – HFTs should set cautious, predefined limits on the number of financial instruments being traded, the price, value and number of orders, the strategy positions, and the number of trading venues to which orders are sent; and
- annual self-assessment and stress testing.

In relation to the "kill functionality", the Delegated Regulation clarifies that unexecuted orders include those originating from individual traders, trading desks or, where applicable, clients.

The requirements in relation to pre-trade controls on order entry appear to have been strengthened. For example, the apparent discretion of an HFT to block or cancel orders if they are aware that a trader does not have permission to trade a particular financial instrument under the draft RTS has been removed – under the Delegated Regulation, HFTs are required to block or cancel orders in such circumstances.

In addition, under the draft RTS, pre-trade controls could be overridden in relation to a specific trade with the full knowledge of risk management staff. However, under the Delegated Regulation, this can only happen if verified by the risk management function and authorised by a designated individual of the HFT.

Chapter III of the Delegated Regulation sets out similar requirements for DEA providers as those set out in the draft RTS and requires a DEA provider to:

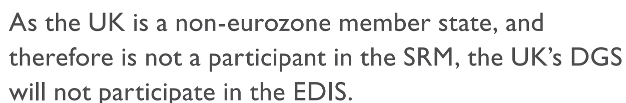
- establish policies and procedures to ensure that trading of its DEA clients complies with the regulatory requirements;
- have sufficient knowledge about the intentions, capabilities, financial resources and trustworthiness of its DEA clients including information about the prospective DEA clients' disciplinary history with competent authorities and trading venues; and
- ensure its trading systems enable it to monitor orders, automatically block or cancel orders, stop order flows, suspend or withdraw DEA services and carry out a review of the internal risk control systems of DEA clients.

Chapter IV of the Delegated Regulation sets out the requirements for firms acting as a general clearing member. These are the same as those set out in the draft RTS and include requirements in relation to due diligence, controls and monitoring of clients and systems, and the setting of position limits and monitoring in relation to those limits.

COUNCIL OF THE EU PUBLISHES PROGRESS REPORT ON THE EDIS REGULATION AND EUROPEAN COMMISSION COMMUNICATION ON COMPLETION OF THE BANKING UNION

On 2 August 2016, the Presidency of the Council of the EU published a progress report on both the proposed Regulation for the establishment of a European Deposit Insurance Scheme (**EDIS**) and the European Commission's (**EC**) November 2015 communication regarding the completion of the Banking Union.

An EDIS is proposed as the third pillar of the Banking Union, the first and second being the Single Supervisory Mechanism (**SSM**) and the Single Resolution Mechanism (**SRM**) respectively. Under the Recast Deposit Guarantee Schemes Directive (2014/49/EU), each EU Member State is already required to have in place a deposit guarantee scheme (**DGS**) in its jurisdiction, in order to protect qualifying persons, who have made deposits into credit institutions, on their insolvency, up to a certain amount. It is proposed that the EDIS would, initially, operate to provide funding only where there has been a liquidity shortfall at a participating DGS, but would eventually provide full cover for all payouts made by participating DGSs. In effect, the EDIS would eventually fully insure the DGSs of participating members states.



As the UK is a non-eurozone member state, and therefore is not a participant in the SRM, the UK's DGS will not participate in the EDIS.

EDIS progress report

The progress report states that member states have taken divergent views on the desirability and timing of the introduction of an EDIS as the third pillar of the Banking Union. In particular, the majority of the member states have criticised the absence of a specific impact assessment. According to an informal economic benefits analysis by the Commission Services, a central body would be more suitable in order to ensure a well-functioning scheme and ex ante (i.e. before the event) pooling contributions into a single fund would absorb shocks more efficiently. The Presidency took the view that additional analysis is required.

It was also questioned whether there was a suitable legal basis under Article 114 of the TFEU for the EDIS Regulation. In particular, certain member states argued that the obligation to contribute to the European Deposit Insurance Fund (**DIF**) would infringe member states' budgetary sovereignty. The Presidency has suggested that an Intergovernmental Agreement (**IGA**) should be considered as a possibility to circumvent this question of legality.

Following discussions with certain member states, the Presidency has sought to progress with a more detailed examination of certain elements of the EDIS proposal, starting with the provisions related to the final stage of full EDIS mutualisation. The hope is that if these provisions can be agreed upon, it would become easier to agree on the intermediate steps.

Provisions amended by the Presidency

Following consultation with member states, the Presidency has proposed the following amendments to the EDIS proposal:

- An amendment to include irrevocable payment commitments as means by which institutions may transfer to the DIF, in accordance with requirements to be specified by the EC.
- Inclusion of an automatic derogation from the funding path of the EDIS when a payout event has occurred in respect of a DGS.
- The introduction of an appeal mechanism for certain decisions made regarding the EDIS.

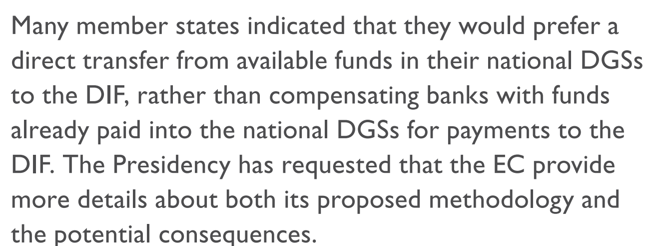
Provisions requiring further refinement/clarification

Member states requested more clarity regarding the EDIS scope, especially with regard to third-country branches or certain types of entity other than credit institutions which may be covered by participating DGSs. The Presidency proposed that the EC should have the authority to perform the mandatory equivalence check and competent authorities should decide whether third-country branches are required to join a national DGS.

Member states have expressed concern about the legality of the "moral hazard" safeguards included in the proposals in respect of incorrect or unwarranted access to EDIS funds from participating DGSs. The Presidency has proposed the establishment of a staggered intervention ladder for compliance with the DGS Directive and the proposed EDIS Regulations, with deposit protection being the key objective and disqualification of DGSs from the scheme only being possible as a last resort. The application of fines as part of this intervention ladder was said to be not legally feasible.

The Presidency took the view that, in addition to those set out in the original EC proposal, there was room for further specification on certain options and national discretions (**ONDs**) contained in the DGS Directive which, in effect, needed to be harmonised amongst participating DGSs in the context of the EDIS. The Presidency proposes a method to define the relationship between the EDIS and participating DGSs without influencing the ONDs of those DGSs. DGSs would therefore remain entitled to take specific national measures (for example, the extension of the coverage for temporarily high balances), as long as they are exclusively financed by national means unrelated to the EDIS.

The Presidency suggested that further clarification was required regarding the insurance level of the EDIS. Among other concerns was the coverage of temporary high balances at the amount of €500,000. Many member states suggested that the amount should reflect the standard of living in their countries and claimed that national legislation hindered harmonisation. Harmonisation based on a minimum amount of loss coverage of temporary high balances through EDIS was suggested as an alternative.



Many member states indicated that they would prefer a direct transfer from available funds in their national DGSs to the DIF, rather than compensating banks with funds already paid into the national DGSs for payments to the DIF. The Presidency has requested that the EC provide more details about both its proposed methodology and the potential consequences.

The new governance structure of the Single Resolution Board (**SRB**) under the EDIS was generally accepted by member states, however some concerns were raised regarding the threshold of involvement of the Board's plenary session, voting modalities and potential conflicts of interest within the SRB.

Provisions requiring fundamental discussion

Certain topics, including the accession and departure of member states to EDIS, the pace and process of mutualisation, the monitoring and exercising of insolvency process by the Board, the calculation of ex ante contributions and the use of common means for alternative measures, have also been identified as requiring further discussion.

EC communication on measures to strengthen the Banking Union

Current achievements

The EU Presidency stated that many of the measures relating to the first and second pillar of the Banking Union had already been implemented. Both the SRM, which has been effective since November 2014, and the SRB, which has been operational since January 2016, were considered to be on track towards achieving their goals. The EC also considered that the SRB was also advanced in pursuing the target of having a resolution plan for all the major banks in the Banking Union by the end of 2016. The Presidency noted that almost all the members of the Banking Union had transposed and implemented all the relevant legal provisions of the single rule book into national law (i.e. the Capital Requirements Directive IV (**CRD IV**), the Capital Requirements Regulation (**CRR**), the Bank Recovery and Resolution Directive (**BRRD**) and the DGS Directive).

Remaining challenges

Member States agreed that the overall construction and resilience of the Banking Union requires enhancement, through further risk reduction and risk sharing. Some of the national DGSs are still vulnerable to large shocks and wider systemic contagion effects. Additionally, concerns about the realisation of the shift from bail-out to bail-in and the minimisation of the use of public funds were also raised. Several member states also called for caution regarding the regulatory treatment of sovereign exposures.

Measures to be introduced

The EC noted that several institutions and bodies were working on measures that were considered to be relevant in the context of the Banking Union, noting that several measures were also relevant to all 28 EU member states and summarised these measures in its communication.

Before the end of 2016, the EC indicated it may propose amendments to CRD IV and the CRR in order to assist in harmonising or further specifying ONDs that have been granted to member states, where they are relevant for the functioning of the Banking Union and the integrity of the single market, and in order to implement and finalise the Basel reforms.

Additionally, a legislative proposal for minimum harmonisation in the field of insolvency law in the context of the Capital Markets Union is expected before the end 2016.

The Commission also announced its intention, towards the end 2018, to review the BRRD and the SRM.

Please contact michael.mckee@dlapiper.com for further information.

UNITED KINGDOM

UK REGULATORY DEVELOPMENTS

FCA PUBLISHES RESPONSIBLE LENDING THEMATIC REVIEW AND FEEDBACK STATEMENT ON COMPETITION IN THE MORTGAGE SECTOR

On 16 May 2016, the FCA published a thematic review (*TR16/4: Embedding the Mortgage Market Review: Responsible Lending Review*) summarising the key findings of its market-wide assessment review of how firms are applying the responsible lending rules introduced in April 2014, which were introduced following the Mortgage Market Review (**MMR**). TR16/4 is the second of two FCA thematic reviews assessing the impact of the MMR, the first being *TR15/9 Embedding the Mortgage Market Review: Advice and Distribution*, which was published on 25 June 2015.

On 16 May 2016, the FCA also published a feedback statement following its Call for Inputs on competition in the mortgage sector issued in October 2015.

Responsible lending thematic review

The FCA's responsible lending rules were introduced with two principal aims: preventing a reappearance of poor lending practices that were common in the years leading to the financial crisis; and placing affordability at the heart of the lending decision process. The FCA carried out the thematic review in order to examine whether firms were lending responsibly; how firms have implemented the responsible lending rules; any root causes of good or poor consumer outcomes; whether there had been any unintended consequences of the rules; and the effect of the rules on competition.

The exercise included reviews of firms' lending policies, individual lending decisions, case study lending scenarios, market data and on-site visits to firms.

A summary of the main conclusions drawn in thematic review are as follows:

- Firms had generally positively engaged with the aims of the responsible lending rules and had implemented them broadly in line with FCA expectations.
- Firms had eliminated previous poor practices, such as self-certification of income or interest-only lending without a credible repayment strategy.
- Despite progress made to date, the FCA found that further improvements could be made regarding firms' affordability assessment processes, monitoring and record keeping of lending decisions.
- On the whole, the FCA held that almost all lending decisions it reviewed appeared to lead to reasonable outcomes, even in cases where firms have taken an unclear approach in terms of the decision-making process.
- The flexibility afforded by the FCA responsible lending rules was used by most lenders when their existing mortgage customers wanted to make changes to their loan. However, the FCA encouraged firms to improve their decision-making process for these customers and urged them to apply exceptions for existing customers more proactively and consistently.
- The FCA did not find evidence that the responsible lending rules had prevented firms from lending responsibly across particular groups, such as older borrowers or self-employed persons (except for in the case of certain lifetime mortgages). However, the FCA took the view that it is important for the mortgage market to continue developing a range of products that could meet the needs of older consumers. Therefore, the FCA announced an intention to include lending to older borrowers as part of its wider strategy work on the ageing population following its February 2016 discussion paper.
- The FCA found that market data showed that the responsible lending rules do not appear to have had a material impact on lending volumes. However, the rules were expected to have a greater impact if interest rates rose or affordability was stretched.

In a message to consumers, the FCA highlighted that:

- Amounts which consumers can borrow vary considerably from lender to lender and therefore consumers should shop around.
- Consumers should contact their existing lender/ mortgage broker towards the end of a particular mortgage deal, as they may be able to move to better terms without passing an affordability assessment.

Feedback statement on competition in the mortgage sector

In its feedback statement, the FCA acknowledged the importance of effective competition in the mortgage industry, noting the vital role that mortgages play in the economy and the significance of mortgage products to consumers. The feedback statement highlighted the key themes emerging from the FCA's Call for Input and concluded that further competition needed to be facilitated in the mortgage sector. The feedback received suggested that firms were embracing both the spirit and the letter of existing rules. The FCA stated that it was keen to improve effective competition in the mortgage sector, with the intention of delivering lower prices, better products and more innovation for consumers.

The FCA considered the four main themes emerging from the Call for Inputs to be:

- Consumers struggle to make effective choices when it comes to assessing and acting on information about mortgage products and the FCA considers mortgage intermediaries to be key to the process.
- More effective use of technology can be achieved in the provision of information and advice regarding mortgages.
- Commercial relationships between different players in the sector's supply chain may give rise to competition concerns, particularly the use of lender panels which may be a potential barrier for smaller firms in entering the market.
- Certain aspects of the regulatory framework were identified that may be negatively impacting on competition (although it is clear that there is no appetite amongst respondents for wide-ranging regulatory change).

Future steps

The FCA plans to continue engaging with the mortgage industry in order to address issues identified in its work to date.

In addition, the FCA plans to launch a targeted market study in Q4 of 2016 focused on consumers' ability to make effective choices with the intention of improving competition in consumers' best interests. The market study intends to address:

- Whether the available tools for helping consumers select mortgages meet their needs.
- The impact of increased intermediation in the mortgage sector on consumer outcomes.
- An assessment of the impact of panel and other commercial arrangements between lenders, brokers and other players in the mortgage supply chain.

Alongside this market study, the FCA will be undertaking smaller pieces of follow up work to the Call for Input, including contributing to the next phase of the Council of Mortgage Lenders (CML) and Which? report on the transparency of mortgage fees and charges; acting on specific aspects of the FCA's current regulatory regime where there is a case for change to improve competition; and working with the mortgage industry to increase competition law awareness in the sector.

FCA FINALISED GUIDANCE FOR FIRMS OUTSOURCING TO THE CLOUD AND OTHER THIRD-PARTY IT SERVICES

On 7 July 2016, the FCA published its finalised guidance for firms outsourcing to the 'cloud' and other third-party IT services (*FG 16/5: Guidance for firms outsourcing to the 'cloud' and other third-party IT services*). The finalised guidance follows the guidance consultation document published by the FCA on 12 November 2015 (*GC15/6*), which was considered in Issue 28 of *Exchange* published back in January 2016.

Following the consultation, the FCA determined that substantial changes to the guidance are not required and therefore the FCA has amended the consultation guidance only where it deemed it necessary to clarify its expectations. In producing the guidance, the FCA worked alongside Project Innovate (a separate FCA initiative to foster innovation in financial services in accordance with the FCA's objective to promote effective competition) to identify areas where the regulatory framework needed to adapt in order to enable further innovation in the interests of consumers.

The FCA acknowledged that the policy contained in the finalised guidance had been designed in the context of the existing UK and EU regulatory framework. The FCA stated that it will assess whether any future changes will be required as a result of any negotiations following the UK's vote to leave the EU.

The original guidance consultation was carried out in response to uncertainty over how the FCA rules might be applied to cloud-based outsourcing. 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. In the 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.

The PRA also published a note *(Outsourcing functions to the Cloud)* in relation to cloud outsourcing, in which it stated that it was working closely with the FCA on matters relating to the cloud and other types of outsourcing.

The main feedback issues raised following the guidance consultation of November 2015 were included in the Annex to the finalised guidance. The feedback touches on the definitions of the 'cloud', legal and regulatory considerations, risk management, international standards, oversight of service providers, data security, the Data Protection Act 1998, effective access to data, access to business premises, relationship between service providers, change management, continuity and business planning, resolution and exit planning. Having taken into consideration the respondents' views, the FCA made certain minor amendments to the finalised guidance document including the following:

- The FCA amended its guidelines to note that identification of all providers in the supply chain of outsourced service will not always be necessary, however it will remain relevant to those services related to the regulated activity being provided.
- Similarly, the FCA amended its guidelines clarifying that the requirement to review all sub-contracting arrangements applies only to those relevant to the provision of the regulated activity.
- The FCA agreed with the feedback that it would be helpful to reference specific considerations regarding transferring data outside the EU and therefore included a short statement in the guidelines signposting existing guidance from the ICO. The FCA also modified its guidelines clarifying that firms should agree on a data residence policy with the provider, that sets out the jurisdictions where their data can be stored, processed and managed.
- The FCA took the view that in certain circumstances, physical access to data centres was necessary for a firm to meet its regulatory requirements. It amended its guidance, clarifying that "business premises" is a broad term and may include head offices and operations centres, but not necessarily data centres.
- The FCA agreed with the feedback suggesting that the requirement for exit plans to be "regularly rehearsed" was unduly onerous and would place firms in a position where they were reliant on the provider of outsourced services. The guidelines now state that exit plans must be "fully tested".

FCA CONSIDERS PROMOTION, CONFLICTS OF INTEREST AND GOVERNANCE OF DARK POOLS IN THEMATIC REVIEW

On 21 July 2016, the Financial Conduct Authority (**FCA**) published the results of a thematic review, in which they examined 'dark pools', which include broker crossing networks (**BCNs**) and 'dark' Multilateral Trading Facilities (**MTFs**). Dark pools are trading venues with no pre-trade transparency where the price and volume of all orders are hidden and anonymous.

The FCA found that users welcome the additional liquidity, the lower risk of information leakage and the potential beneficial impact on pricing and costs that dark pools offer. The FCA thematic review did not observe any failures to comply with regulatory requirements but did identify a number of areas where improvement is required by dark pool operators.

In light of the FCA's findings, dark pool operators should:

- review promotional materials to ensure they clearly and consistently explain pool operation to users and ensure there is a robust internal governance process for the review and approval of marketing material with legal/compliance oversight;
- improve the monitoring of activity in their pools with a focus on operational integrity, best execution, client preferences and unwanted trading activity including market abuse; and

- do more to identify and manage conflicts of interest, including strengthening policies and procedures for escalation and oversight, as well as regularly refreshing independent assessments.

Dark pools, market fragmentation and regulatory change

Dark pools provide users with an alternative trading venue to public exchanges, such as the London Stock Exchange. By trading 'in the dark' as opposed to on 'lit' markets, dark pool users do not disclose the size or the price of their trades to the wider market. Historically, this enabled institutional investors to execute large block orders at better prices than that which was possible on lit markets, where the size of their order would result in an unfavourable price movement against them.

Today, dark pool users may have a mix of orders with differing objectives underway at any point in time and spread across a number of dark and lit trading venues. The breaking up of a single order (parent) into smaller (child) orders, once the preserve of more sophisticated traders, is now common practice and built into the vast majority of automated trading activity. Dark pool users are wholesale investors. The FCA noted that while retail investors may have all or part of their order processed by a broker in a dark pool, there are no operators who provide retail clients with direct access to UK dark pools.

The FCA's thematic review comes in the context of increasing technological advances in electronic trading, and significant fragmentation of the UK equity market. Whilst the FCA noted that electronic trading across multiple trading venues, including dark pools, has led to higher speeds and lower costs, the regulator acknowledged concerns that price transparency and price formation may be at risk if dark markets, which derive their prices from lit markets, become disproportionally large compared to lit markets. The FCA stated that at present, dark market volumes are considered too small to pose an imminent threat to the price formation process, but that they would continue to monitor market developments.

The FCA reminded dark pool operators that the upcoming MiFID II regulations will have a significant impact on wholesale markets, including a direct impact on BCNs, which represent a sizeable component of market liquidity. Whether and how firms may choose to restructure their existing businesses, including dark pools, remains uncertain pending the finalisation of MiFID II rules.

Thematic review

The FCA thematic review involved a desktop review of practitioner and academic research, as well as marketing materials produced by dark pool operators since 2014. The FCA then sought detailed information from a sample of dark pool users and operators. After reviewing this information, the FCA met buy-side investors who are significant users of dark pools. From these discussions, the regulator sought to understand the user experience as these markets have evolved, the role of dark pools in their trading activities and specific issues that they thought worthy of note.

The FCA then met with operators of dark trading venues, primarily focusing on BCNs, but also meeting dark MTF operators, to evaluate the products and services they provided, their governance structure and the identification, management and disclosure of conflicts of interest.

Areas for improvement

The FCA found that dark pool operators have responded to public concern and regulatory interventions by addressing business model design, promotional materials in use, and the management of conflicts of interest. Nonetheless, poor practices and areas for improvement were identified. A number of these areas are highlighted below.

(I) Client onboarding and preferences

Users are sensitive to who is in the pool with them. BCN operators generally offer their users the ability to restrict counterparties or counterparty types against whom their orders are allowed to execute. For example, users may choose to restrict or wholly avoid interaction with high frequency traders (**HFT**) or electronic liquidity providers. Whilst operators noted that the number of users making use of these restrictions was small, the FCA found that the collection, storage and processing of these preferences was difficult to audit, and systemically weak across the industry. The FCA also found that dark pool operators were not sufficiently systemic in ensuring

the prevention of trades with restricted counterparties. As a result, a user may find its order being matched with a counterparty that it has a clear preference not to trade with. Weak processes may give rise to the risk that the dark pool operators are not meeting their best execution obligations. Best execution obligations include the obligation to ensure that orders are executed in line with specific client instructions where provided.

(2) Operational design and integrity

The FCA also considered how dark pool operators managed the conflict between routing a client's order in the best interest of the client and operating a dark pool. The FCA noted that bank operators consistently route orders to their own BCN pool before routing elsewhere. The FCA stated that this was acceptable, provided that operators adhere to best execution obligations, avoid positive or negative venue discrimination, manage resting times and support and evidence all of the above by actively monitoring trade activity.

The FCA also observed that some operators sent client orders to their own BCN pool and then forwarded orders automatically (partially executed or otherwise) to other BCNs under a Reciprocal Access Agreement. Router technology can stipulate basic order instructions but may not necessarily preserve specific client preferences. The FCA observed that users were not clear on whether their preferences were preserved under onward routing and had no way to monitor or verify if those preferences were honoured.

The FCA also identified the poor practice of in-house trading desks being granted access to BCNs via different infrastructure to clients, which gave operators a potential latency advantage, constrained only by management controls.

(3) Monitoring of activity in the pool

The FCA stated that monitoring capacity was the weakest area of the end-to-end trading process related to dark pools that the regulator identified in the thematic review. The regulator noted that the ability to analyse and report on individual client transaction-level trading activity on the same day is beyond the technical capacity of most operators; as most take several days or a week to generate reports. Whilst the regulator acknowledged the challenge of trade monitoring in an ultra-fast environment, the regulator stated that all operators must be able to monitor and ensure that they are meeting their best execution obligations, and correct any deficiencies where appropriate.

All pool operators have responsibilities to monitor for market abuse, the integrity of their operational platform and those features which they have promoted as attributes of their pool. Where operators purport to be able to identify and protect against unwanted activity ('toxicity' or 'aggressive HFT' for example) they must ensure that they have in place appropriately and clearly defined metrics and controls in order to be able to effectively monitor and take action against firms that exhibit unwanted types of activity.

FCA FINDS FAILINGS IN INSURANCE FIRMS' OVERSIGHT OF APPOINTED REPRESENTATIVES

On 22 July 2016, the Financial Conduct Authority (**FCA**) published the results of a thematic review in which the FCA found significant shortcomings in the control and oversight of appointed representatives (**ARs**) by their principal authorised firms in the general insurance sector.

The FCA found that almost half of the principal insurance firms could not demonstrate that they understood the nature, scale and complexity of the risks arising from their ARs' activities. The FCA also found examples of potential mis-selling and customer detriment resulting from the actions of the ARs, which principal firms had failed to identify.

As a result of the findings, the FCA has intervened early, taking the following actions in relation to five of the principal insurance firms:

- commissioning two section 166 skilled person reviews to assess whether detriment has been suffered by customers from mis-selling and consider the adequacy of systems and controls;
- asking two firms to cease sales activities;

- agreeing the imposition of requirements on all five firms' regulatory permissions to stop them taking on new ARs; and
- considering the need for customer redress and any further regulatory action.

In light of the FCA's findings, firms should consider their processes and controls around ARs.

Thematic Review

The FCA conducted an online survey of 190 principal authorised general insurance and insurance mediation firms. These 190 principal firms had over 6,000 ARs with 75,000 individual representatives operating in 15,000 locations, selling more than 10 million policies (predominantly to retail customers) and generating annual revenues of more than £500 million.

The FCA then selected a sample of 15 principal firms using a risk-based approach and obtained further information on these firms. These 15 principal firms had 783 ARs with 10,594 representatives operating in 1,684 locations. FCA staff visited 14 of the 15 selected principal firms and 25 ARs. During the visits, FCA staff met with and interviewed senior management and staff, reviewed policies and procedures, contractual documentation, customer-facing documentation and customer files, and listened to sales calls.

FCA findings

The FCA found that almost half of the 15 principal firms could not demonstrate that they considered and understood the nature, scale and complexity of risks arising from their ARs' activities and, in particular, the risks these activities presented to customers. Some ARs conducted activities outside their principal's core area of expertise, where the principal lacked the ability or resources to oversee them effectively.

The FCA also found that over half of the 15 principal firms could not consistently demonstrate that they had effective risk management, oversight and control frameworks to identify, monitor and mitigate the risks arising from their ARs' activities. The FCA found that many principal firms had shortcomings when engaging ARs including in categorisation, setting up multiple principal arrangements and implementing the approved persons regime (i.e. failing to ensure that ARs were fit and proper for their role).

Many principals could not demonstrate that they had adequately considered the solvency and suitability of their ARs, nor the impact on their own compliance with the authorisation threshold conditions and the adequacy of their controls and monitoring resources.

Impact on consumers

The FCA found that shortcomings in principal firms' risk management, control and oversight meant that they were not able to ensure their ARs' compliance with relevant rules – notably the requirements of the FCA's Principles for Business and the Insurance: Conduct of Business Sourcebook – and this gave rise to risks for their customers.

In a third of the sample principal firms, the FCA found examples of potential mis-selling and customer detriment due to AR actions – most of which principal firms had previously failed to identify. These included customers buying products they did not need, under which they may be ineligible to make a claim, and/or without enough information to make an informed choice. In one case, the FCA found significant evidence of actual mis-selling leading to actual customer detriment: as a result of poor sales practices and inadequate sales calls, some customers were poorly informed and bought warranty insurance for which they were clearly ineligible.

Regulatory obligations

In addition to disciplining some of the 15 principal firms included in the sample, the FCA stated that it expected principal authorised firms to comply with their regulatory obligations to:

- consider the impact of ARs on their own business model and ability to meet threshold conditions,
- assess the solvency and suitability of their ARs,
- take reasonable steps to establish an appropriate risk management framework to identify and manage the risks ARs present to their business,
- establish compliant contractual arrangements with their ARs,
- have adequate controls over their ARs' regulated activities for which the principal has responsibility, and

- have adequate resources in place to monitor and enforce compliance with the relevant requirements that apply to the regulated activities for which the principal is responsible.

BANK OF ENGLAND AND PRA CONSULT ON ENFORCEMENT DECISION MAKING COMMITTEE

On 22 July 2016, the Bank of England (**BoE**) and the Prudential Regulation Authority (**PRA**) issued a joint consultation paper (CP/EDMC2016) on the proposed establishment of the Enforcement Decision Making Committee (**EDMC**), which would be established in order to strengthen the independence and robustness of the decision making process in contested enforcement cases. Contested enforcement cases are those matters which do not proceed to successful settlement by the BoE operating through its executive settlement processes.

The proposed enforcement regimes in respect of which the EDMC would make decisions were suggested as:

- The PRA.
- The BoE in respect of its supervision of Financial Market Infrastructure (**FMI**), i.e. central counterparties, recognised payment systems and securities settlement systems.
- The BoE as the UK's resolution authority. The Resolution Directorate of the BoE coordinates use of the BoE's powers under the Banking Act 2009 in relation to the resolution of failing banks, building societies, investment firms and central counterparties in accordance with the statutory objectives of the Special Resolution Regime.

The BoE has also suggested that the EDMC should be used in enforcement cases in relation to the issuance of Scottish and Northern Irish banknotes by banks that are authorised to issue their own banknotes (in England & Wales, only the BoE may issue banknotes). A separate consultation will be conducted with these authorised banks.

The joint consultation on the formation of the EDMC forms part of a wider effort of the BoE to produce a consolidated and comprehensive external policy statement regarding its enforcement processes. The relevant guidance is intended to be published in 2017.

The joint consultation is published building on the findings of:

- the HMT Review published on 18 December 2014 which focussed on the transparency, effectiveness, speed and objectivity of the FCA's and PRA's enforcement decision-making process;
- the BoE's three year Strategic Plan titled "One Bank", in which the BoE proposed to go beyond the HMT Review recommendations and establish the proposed EDMC model across all areas where the BoE has been granted enforcement powers; and
- the Bank of England and Financial Services Act 2016, which will change the BoE's corporate governance structure by rendering the PRA an authority within the BoE rather than a subsidiary of the BoE, and creating the Prudential Regulation Committee which will replace the PRA Board as the PRA's key policy decision making body.

The BoE's proposed model is based the FCA's Regulatory Decisions Committee. Both the BoE and the PRA propose that EDMC and its members should be independent from the BoE's executive management structure.

Establishment of the EDMC

In the consultation paper, the BoE proposes the appointment of a panel for each contested enforcement case, addresses the jurisdiction of the EDMC and its scope of decision making, sets out the EDMC's procedures in contested cases and addresses co-operation with the FCA on joint or parallel investigations.

The EDMC would be established by the Court of Directors of the BoE (**Court**). The Court would appoint up to 15 members, but these members would not be BoE employees. The Court would appoint members with relevant expertise and significant experience in making independent and evidence-based decisions, to ensure that the relevant experience is applied appropriately to the regulated population. The Court would ensure that there was an appropriate mix of expertise across the EDMC's membership. Decision making powers would be delegated to the EDMC by the PRA Board and the Court, as appropriate.

It is proposed that a panel of at least three members would be selected to consider a particular contested enforcement case. The EDMC process would be administrative rather than judicial, i.e. the EDMC would not be an appeal body, but would constitute the final stage of the administrative decision-making process of the PRA or BoE, as appropriate, in a contested enforcement case. Therefore, an EDMC decision could be referred subsequently to the relevant judicial body for appeal.

The consultation paper proposed that the EDMC would consider all of the PRA and BoE contested enforcement statutory notice decisions and would meet as often as is necessary to discharge its functions. Each member would be entitled to vote on a matter under consideration and decisions would be taken by a majority vote with the Chairperson having the casting vote. The EDMC would be involved in the issuance of Warning Notices and Decision Notices.

In respect of joint or parallel investigations with the FCA, the FCA and BoE would continue to treat each investigation on a case-by-case basis, as it was thought to be too early to adopt a settled approach to contested cases following such investigations. It is the regulators' intention to provide more detailed guidance on these matters once they have more experience of joint investigations (the number of joint investigations carried out to date is comparatively small).

The consultation closes on 21 October 2016.

FCA CREDIT CARD MARKET STUDY

On 26 July 2016, the FCA concluded its study of the credit card market, which was launched in November 2014. The study was launched soon after the FCA took over regulation of consumer credit in the UK. The FCA has published its final findings report *(MS14/6.3: Market Study: Credit Card Market Study – Final Findings Report)*. This report builds on an interim report *(MS 14/6.2: Credit Card Market Study: interim report)* published by the FCA on 3 November 2015. In the final findings report, the FCA sets out new measures to encourage customers to shop around more effectively, take better control of their spending and, where appropriate, repay balances faster.

FCA concerns about the credit card market

Although the FCA's final findings indicate that competition is working fairly well for most customers, the FCA was concerned that some customers were unable to find the best product for their needs and that higher credit risk customers were faced with a more limited choice in the market. In addition, the FCA found that competition focused more on initial promotional offers and rewards than on interest rates and charges outside of these initial periods. As a result, the FCA has proposed a package of remedies to help customers obtain the best deal and search the market effectively, and to prompt customers when they are nearing the end of a promotion period.

The FCA also expressed concern about the level of potentially problematic credit card debt. In particular, the FCA focused both on over-borrowing and under-repaying leading to customers paying more in debt service costs and taking longer to pay off debt than is necessary. Importantly, the FCA also highlighted that firms could do more to identify customers who are in financial difficulties at an earlier stage and help them manage their repayments.

During its review, it had been put to the FCA that customers who use their cards to borrow (known as 'revolvers') were subsidising those who primarily use their cards for payment transactions (known as 'transactors'). Despite this, the FCA did not find that any such cross-subsidisation materially affected competition in the credit card market and that firms typically designed products to at least break even over a five-year period for all behavioural types assessed. While revolvers were typically more profitable to firms, transactors were typically profitable on a standalone basis.

Current thinking of the FCA on a package of remedies

The objective of the FCA's proposed remedies was to reduce the number of customers in potentially problematic debt and put customers in control of their own borrowing.

In relation to shopping around and switching, the FCA stated it was undertaking wider work to open up access to account-level data to enable customers to obtain products which were suitable to their individual requirements. The FCA also proposed taking forward wider work on price comparison websites to ensure clearer standards. This included feeding into the CMA's market investigation into price comparison websites.

The FCA took the view that customers should be reminded of the expiry of a promotional offer so that they are informed about the rate of interest they might incur on expiration and, in that context, encouraged to consider whether the credit card would meet their needs following the expiry of the promotional offer period. The FCA noted that the industry, as represented by the UK Cards Association, agreed to inform customers that their promotional offer is due to end.

In relation to higher credit risk customers, the industry has agreed to a number of remedies which will help such customers avoid the risk of incurring penalty charges. For example, the industry will alert customers at a set point of credit limit utilisation and enable customers to request a payment date which is later than their own pay day. The FCA has also committed to promoting and facilitating the use of quotation searches to enable customers to search the market without damaging their credit score.

The FCA stated it was exploring firms' approach to repayments. It proposed that stated minimum repayments should be removed to encourage customers to choose a repayment amount according to how quickly they want to pay back their debt. For example, the FCA suggested that firms may be required to disclose how long it would take a customer to repay that customer's current balance at the current rate of repayment in each monthly statement. Moreover, the FCA stated it would consider the relative merits of an increase in the minimum repayment rate to encourage customers to repay their balance at a faster rate.

The FCA announced that it also intended to consult on a proposed rule to give customers more control over their credit limits, by requiring customers to opt-in for credit limit increases in order to help prevent unaffordable borrowing.

In order to address potentially problematic debt, the FCA stated its intention to consult, later in 2016, on rules requiring firms to identify early signs of debt management problems and whether to intervene accordingly; and to take action to intervene when a customer has been indebted for a certain period, for example, by suggesting a structured repayment plan.

Next Steps

These measures may be implemented via FCA rules and guidance following further analysis and consultation. If the FCA concludes that this would be the most appropriate way to implement the proposed remedies, it is likely that these will be implemented later this year. Other measures may be implemented via voluntary industry agreements.

FCA FURTHER CONSULTS ON MIFID II IMPLEMENTATION

On 29 July 2016, the Financial Conduct Authority (**FCA**) published its second consultation paper (**CP16/19**) on the implementation of the Markets in Financial Instruments Directive II (**MiFID II**).

MiFID II will take effect on 3 January 2018 replacing the first MiFID (**MiFID I**). MiFID I sets the regulatory framework for the buying, selling and organised trading of shares, bonds, units in collective investment schemes and derivatives across the European Union. MiFID II brings new rules on market structures, transaction reporting and behavioural standards of market participants, as well as enhancing regulatory authority over those markets.

The FCA clarified that following the result of the United Kingdom's referendum on its membership of the EU, firms must continue to abide by their obligations under UK law, including those derived from EU law. These will include MiFID II and the underlying regulatory technical standards.

The FCA consultation paper touches upon a variety of issues, most of which are not expected to significantly increase the regulatory burden for entities, either regulated or unregulated. An indicative list of the provisions which seem most likely to have material implications for firms, as well as of their potential consequences is provided below. The key changes affect position limits, position management and

position reporting in commodity markets, conflicts of interest rules, complaints handling, client assets and whistleblowing.

Position limits, management and reporting

a) Rule requirement:

The FCA indicates its approach to the introduction of rules on position limits, position management and position reporting, which were completely absent in the context of MiFID I. Circumstances in which exemptions may be granted are also described.

b) Implications:

i. Persons trading commodity derivatives, whether authorised or not, will need to reconfigure their trading activity so as to comply with the proposed position limits.

ii. More specifically:

- some authorised firms will have to apply for exemptions from position limits, while others might need to make arrangements to report their positions; and
- trading venues will be required to provide position reports to regulators on a daily basis and aggregated information about positions to ESMA on a weekly basis, as well as review and adapt current rules and procedures regarding monitoring and management positions.

Conflicts of interest

a) Rule requirement:

MiFID II may not fundamentally change the existing provisions regarding the application of analogous requirements for Article 3 firms, common platform firms or conflicts of interest. However, it strengthens certain key requirements of the conflicts of interest rules and requires firms to not only manage, but also take 'appropriate' steps to prevent conflicts of interest. Moreover, enhanced governance standards expected of management bodies are introduced and the latter are required to take on clear business responsibilities, including setting strategic objectives and defining the risk strategy and internal governance of firms.

a) Implications:

i. Firms may need to update their existing organisational and administrative arrangements with specific regards to disclosure. Given that the appropriateness standard is still unclear in terms of its meaning, firms should be careful when balancing their reporting and their conflict-preventive obligations.

ii. Common Platform firms may need to review their internal governance arrangements and risk culture to meet the higher standards.

Complaints handling, client assets and whistleblowing

a) Rule Requirement:

MiFID II introduces new rules on complaints handling, client assets and whistleblowing, which are not expected to have a material impact on UK firms, since similar provisions are already in place under UK law.

b) Implications:

Some small additional cost may have to be borne by firms as a result of the proposed extension in scope of complaint record-keeping and reporting requirements to complaints made by professional clients.

Next steps

The second consultation closes on 28 October 2016. A third consultation is expected to be published by the FCA in order to deal with the remaining issues regarding the implementation of MiFID II, including changes to the Conduct of Business sourcebook (COBS), material on product governance and further changes to the Perimeter Guidance manual (PERG). A single policy statement covering all implementation aspects will also be published in 2017.

Key regulatory messages

- Regulatory measures proposed by the FCA in CP 16/19 are not generally expected to inflict a significant burden or cost on firms.
- However, firms will have to comply with the new enhanced regulatory provisions and adjust their rules and systems accordingly.

- Provisions concerning position limitations, management and reporting, conflicts of interest and corporate governance and organisation will require additional attention by the firms, as these are the provisions that will probably result in the greatest amount of regulatory changes.

FCA INTRODUCES NEW RULES TO INCREASE TRANSPARENCY AND ENGAGEMENT ON RENEWAL OF GENERAL INSURANCE CONTRACTS

On 10 August 2016, the FCA published a policy statement *(PS16/21: Increasing transparency and engagement at renewal in the general insurance market – feedback on CP15/41 and final rules and guidance)*. This policy statement follows its consultation paper *(CP15/41: Increasing transparency and engagement at renewal in the general insurance market)* published on 3 December 2015. The final rules and guidance set out in the policy statement aim to increase engagement and promote competition by enhancing disclosure at renewal in general insurance markets.

Implementation of the new rules and guidance

The FCA announced it would amend the Insurance: Conduct of Business sourcebook (**ICOBS**) to implement the new rules and guidance set out in PS16/21, which will affect both firms and customers in retail general insurance markets.

The new rules (set out in Annex 1 of the policy statement) will apply when a firm proposes that the customer renews a general insurance policy. Under the new rules, the firm proposing renewal must provide customers with certain information beforehand.

The new rules and guidance will require:

1. Firms to disclose the premium that would need to be paid by the customer for renewal in good time, in order to allow customers sufficient time to seek quotes from alternative insurance providers.
2. The provision by firms of the amount of the premium paid by the customer the previous year or, where the customer's circumstances have changed during the course of the policy, firms must instead state at renewal an annualised premium, reflecting any mid-term adjustments in the policy premium. The purpose of this rule is to enable customers to have two comparable premiums, based on their current circumstances.
3. A statement to be made by firms indicating that customers are able to compare prices and levels of cover provided by alternative providers. Following CP15/41, the FCA altered this shopping around disclosure, so that customers are now encouraged to consider whether the level of cover offered is appropriate to their needs as well as the price.
4. A further statement to be made by firms further encouraging customers to shop around if the proposed renewal would be the fourth or subsequent renewal the customer has made in respect of the policy. The FCA has suggested the following wording: "You have been with us a number of years. You may be able to get the insurance cover you want at a better price if you shop around."

Following the original consultation, the FCA has brought 10-month policies within the scope of the final rules and guidance to ensure that firms cannot easily circumvent the new requirements.

Firms must communicate the information set out in points 3 and 4 above clearly and accurately, in writing or another durable medium, in a way that is accessible and draws customers' attention to it as key information. Moreover, firms are advised to have regard to the record-keeping obligations set out in ICOBS 2.4.1G and ensure that appropriate systems and controls are in place with respect to the adequacy and sufficiency of its records. This is to ensure that firms fulfil their regulatory and statutory obligations and will enable the FCA to monitor compliance with the requirements under the regulatory system.

Next Steps

Following CP15/41, the FCA announced it has extended the proposed implementation deadline by three months to ensure that all affected firms have enough time to implement its proposals. Accordingly, firms must make the relevant changes to their renewal communications in line with this policy statement by 1 April 2017.

FCA STATEMENT ON REVIEW OF CLIENT MONEY RULES FOR INSURANCE INTERMEDIARIES

On 16 August 2016, the Financial Conduct Authority (**FCA**) issued an update to firms in relation to its review of client money rules for insurance intermediaries. The FCA stated that proceeding with proposed rule changes to the Client Asset Sourcebook (**CASS**) would not, at this time, be proportionate. This update follows a prior consultation and review of the client money rules for insurance intermediaries by the FCA's predecessor, the Financial Services Authority (**FSA**).

FSA Consultation Paper on review of client money rules for insurance intermediaries

On 28 August 2012 the FSA released Consultation Paper 12/20 (**CP 12/20**) requesting comments on proposed changes to Chapter 5 of the Client Assets Sourcebook (**CASS 5**). The proposed changes to CASS 5 regarded segregation and risk transfer, distribution and transfer of client money, diversifying client money, record keeping and reconciliations, governance, segregation and placement of client money and reporting to the FSA. The FSA stated at the time that further amendments to the client money rules for insurance intermediaries may be considered in the future. It also confirmed its intention to delete existing rules in CASS 5 and replace them with a new CASS 5A, incorporating the proposed amendments and following the relevant FSA review of CASS 5, which revealed poor understanding of the rules, poor compliance and missing or incomplete documentation.

FCA follow-up to the CP12/20

Since the publication of the CP12/20 consultation paper, the FCA stated it had been working closely with the industry and it is optimistic that there was an increased interest in protecting client money. The FCA stated it had taken a number of initiatives, such as an enhanced proactive CASS supervision strategy for general insurance intermediaries and an updated reporting requirement for general insurance intermediaries holding client money which enables the FCA to collect more robust information from these firms. It announced that no rule changes to CASS 5 would be pursued without a new consultation, while the existing rules would remain in place and that general insurance intermediaries holding client money or operating under risk transfer agreements are still required to comply with those rules.

Future Steps

The FCA stated it will continue to work with general insurance intermediaries to mitigate risks, such as conditional risk transfer and incorrect client money calculations and reconciliations. The consultation process has been designed to encourage stakeholders to share their views with the FCA so that the right policy is put in place before changes to rules are made. The FCA decided that proceeding with the proposed rule changes would not, at this time, be proportionate. That decision was based on the feedback received on the original proposals, the re-consideration of their costs and benefits following new requirements brought about by the Financial Services Act 2012 and the review of additional data collected about the impact of the proposals on smaller firms.

UK ENFORCEMENT

FORMER BARCLAYS BANK EMPLOYEES SENTENCED TO A TOTAL OF 17 YEARS FOLLOWING LIBOR MANIPULATION CONVICTION

Four former Barclays Bank plc employees have been sentenced to a total of 17 years in prison following their conviction for conspiracy to defraud. The defendants were found to have manipulated US dollar LIBOR submissions during the period between June 2005 and September 2007.

Following an 11 week trial, Jay Vijay Merchant, the most senior of the defendants and a LIBOR trader, was sentenced to six-and-a-half years' imprisonment, while his junior, Alex Julian Pabon was sentenced to two years and nine months' imprisonment. Jonathan James Mathew, a LIBOR submitter, was sentenced to four years' imprisonment. Peter Charles Johnson, a submitter and head US dollar cash trader, pleaded guilty in October 2014. As a result, he was sentenced to four years in prison and was required to pay a fine to £114,501.19 within 14 days or risk a default sentence of 2.5 years, as well as a further £30,000 in costs. The Serious Fraud Office (**SFO**) is currently seeking

the retrial of two co-defendants, Stylianos Contogoulas and Ryan Michael Reich after the first jury could not reach a verdict.

In passing sentence, HHJ Leonard QC stated that the defendants had a high culpability and their behaviour showed an absence of integrity. A similar statement was made by David Green QC, Director of the SFO, following the announcement of the verdicts in respect of Merchant, Mathew and Pabon, stating that the key issue in the case was dishonesty and noting the extensive cooperation between the UK and the US with regards to convictions in respect of LIBOR manipulation.

Including these convictions, the SFO's investigation into LIBOR has resulted in a total of five convictions, with Tom Hayes being the first person to be convicted back in August 2015. A total of 19 individuals have been charged so far, whilst criminal proceedings have been instigated in respect of five additional persons currently residing abroad. Six defendants were acquitted of charges in January 2016 in the second LIBOR trial. Six further individuals are awaiting trial for the alleged manipulation of EURIBOR, due to take place on 4 September 2017.

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NEW YORK DFS REQUIRES TRANSACTION MONITORING AND FILTERING PROGRAMS THAT ADDRESS ANTI-MONEY LAUNDERING AND SANCTIONS COMPLIANCE SHORTCOMINGS

The New York Department of Financial Services (**NYDFS**) has published a final rule aimed at addressing purported shortcomings on the part of financial institutions in detecting and preventing money laundering and sanctions violations.

Who is subject to the rule?

There are essentially three groups of financial institutions subject to the final rule, referred to collectively as "Regulated Institutions". The first group includes banks, trust companies, private bankers, savings banks and savings and loan associations that are chartered under New York banking law. The second group includes foreign bank branches and foreign bank agency offices licensed under New York banking law. The third group includes check chasers and money transmitters licensed under New York banking law.

What is required?

Regulated Institutions must enhance elements of their Bank Secrecy Act and anti-money laundering (**BSA/AML**) compliance program and sanctions compliance program in order to meet standards set forth by the final rule. The NYDFS refers to the actions outlined in the final rule as clarifications of requirements, suggesting that they do not view them as newly created requirements. Under the final rule, Regulated Institutions must ensure their transaction monitoring program and filtering (or screening) program are reasonably designed to comply with risk-based safeguards outlined in more detail below. Regulated Institutions must also adopt an annual board resolution or senior compliance officer finding (the choice is that of the institution) certifying compliance with the NYDFS regulation.

Transaction monitoring program

Each Regulated Institution must maintain either a manual or automated transaction monitoring program reasonably designed to identify potential BSA/AML violations after transactions are executed and report suspicious activity. At a minimum and to the extent applicable, to be compliant with the rule a program must:

- Be based on an ongoing and comprehensive risk assessment of the Regulated Institution that takes into account the institution's size, staffing, governance, businesses, services, products, operations, customers, counterparties and the geographies and locations of its operations and business relations.
- Be reviewed and periodically updated to reflect changes to applicable BSA/AML laws, regulations and regulatory warnings, as well as other information determined by the institution to be relevant.
- Appropriately match BSA/AML risks to the institution's businesses, products, services, customers and counterparties.
- Include detection scenarios with threshold values and amounts designed to detect potential money laundering and other suspicious or illegal activities with documented and articulated detection scenarios and the underlying assumptions, parameters and thresholds. The final rule specifically requires ongoing analysis of the continued relevance of these detection scenarios, underlying rules, thresholds, parameters and assumptions.
- Test the program's effectiveness (pre- and post-implementation), including, as relevant, program governance, data mapping, transaction coding, detection scenario logic, model validation, data input and program results.
- Include protocols for:
  - investigation of alerts generated by the program,
  - decisions on which alerts prompt filings or other actions,
  - identification of individuals and operating areas responsible for decision-making, and
  - documentation of investigations and decision-making processes.

Filtering program

Each Regulated Institution must maintain either a manual or automated filtering program that is reasonably designed to prevent transactions that are prohibited by US sanctions laws and regulations implemented by Treasury's Office of Foreign Assets Control (**OFAC**). The final rule specifically requires filtering programs to:

(1) Be based on an ongoing and comprehensive risk assessment of the Regulated Institution that takes into account the institution's size, staffing, governance, businesses, services, products, operations, customers, counterparties and the geographies and locations of its operations and business relations.

(2) Match names and accounts, through the use of software, tools or manual processes, in each case based on the institution's particular risks, transaction, and product profiles. While not mandating specific technology, the final rule does suggest that institutions should use algorithms or "fuzzy logic" to identify potential matches that are not exact.

(3) Test the program's effectiveness (pre- and post-implementation), including, as relevant, a review of data matching, an evaluation of whether the OFAC sanctions list and threshold settings map to the institution's risks, the logic of matching technology or tools, model validation, and data input and program results.

(4) Be subjected to ongoing analyses and assessments of the logic and performance of the matching technology or tools, coverage for changes to the OFAC sanctions list and threshold settings to ensure continued mapping to the institution's risks.

Requirement to document the intent and design of the program's tools, processes or technology

Both the transaction monitoring and filtering programs must identify all sources of data, validate the accuracy and quality of the data and ensure complete and accurate extraction and loading of data.

To ensure effective and efficient management of the programs, the final rule requires management oversight, periodic training, case management, appropriate funding, a vendor selection process if applicable, and qualified personnel or outside consultants.

To the extent that a Regulated Institution determines material improvement, updating or redesign is necessary to satisfy the final rule, the institution must document these issues and plans, recognising that the NYDFS may review such documentation.

Certification

Annually by April 15, each Regulated Institution must submit to the Superintendent of the NYDFS either a board resolution or senior officer compliance finding (in the form provided by the NYDFS as an attachment to the final rule) that the certifying party has reviewed documents, reports, certifications and opinions of such officers, employees, representatives, outside vendors and other individuals or entities as necessary and taken all steps necessary to confirm, to the best of the certifying party's knowledge, that the Regulated Institution complies with the final rule. Regulated institutions must maintain records supporting the certification for a period of five years, for review and examination by the NYDFS. For these purposes, a senior officer means the senior individual or individuals responsible for the management, operations, compliance and/or risk of a Regulated Institution.

Penalties

Notably, the final rule diverges from the NYDFS's previously proposed rule and omits the explicit reference to criminal penalties for a certifying senior officer who files an incorrect or false annual certification. However, compliance with the final rule will be enforced pursuant to the Superintendent's authority under any applicable laws.

When does the final rule become effective?

The final rule becomes effective on 1 January 2017. The first annual certifications must be filed by 15 April 2018.

Authors' insights

The final rule presents an overlap of AML and sanctions compliance programs that, in practice, may be inconsistent with the approach taken by certain organisations. At the federal level, the agencies and the laws that impose each of the requirements are different, with AML generally implemented by FinCEN under BSA authority and sanctions compliance enforced by OFAC under the authority of various laws, regulations, executive orders and treaties. It is not unusual (and

sometimes is advisable) for AML and sanctions compliance programs within an organisation to operate separately and be managed by different personnel. Such an approach may present complexities as it relates to the annual certification required by the final rule.

The final rule appears to assume parallel coverage of New York state law and federal law as it relates to the definition of money transmission. More specifically, the federal Bank Secrecy Act explicitly exempts some entities from the definition of money transmitter, thereby exempting them from BSA/AML compliance obligations. However, the NYDFS has found certain companies that are exempt from money transmission compliance obligations at the federal level to be within the scope of New York's Transmitters of Money Act, nonetheless. For companies that are not money transmitters under the Bank Secrecy Act but are licensed as money transmitters in New York, the final rule could represent a significant change in their compliance approach and obligations.

Further to the preceding point, the final rule imposes certain suspicious activity reporting obligations on Regulated Institutions by specific reference to the federal regulations for SAR reporting. In implementing SAR reporting obligations on financial institutions under the Bank Secrecy Act, FinCEN mandates automated reporting through online portals that require credentials of the financial institutions. In those instances where New York law is more expansive in its definition of Regulated Institution than the corresponding federal law, it is unclear how a Regulated Institution can file SARs without the associated FinCEN credentials.

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NYDFS FINAL RULE – FURTHER COMMENTARY

This "final" regulation reflects substantial revisions to an earlier draft proposed by DFS last year which appear to respond to a storm of criticism that the initial rule, by expressly threatening criminal penalties against chief compliance officers for inaccurate certifications of compliance, would impede, rather than encourage, enhanced compliance efforts.

Many of the elements of the initial rule remain, but the DFS has now relaxed its attempts to prescribe with specificity the measures that must be implemented. Regulated institutions must now maintain a program "reasonably designed" to monitor transactions; enumerated features of such a program, which were previously specified in the proposed rule without qualification, are now required only "to the extent they are applicable" and "relevant". Similar acknowledgement of institutional discretion may be found in those provisions requiring that regulated institutions maintain a "watch list filtering program" for the purpose of interdicting transactions prohibited by federal economic and trade sanctions. Regulated institutions are now required to maintain a program "which may be manual or automated" and "reasonably designed for the purpose of interdicting transactions". Minimum program requirements are specified, such as testing, "including, as relevant, a review of data matching", but a previous requirement that "watch lists reflect current legal or regulatory requirements" has been scrapped in favour of a more specific reference to the OFAC sanctions list alone.

The proposed rule enjoined regulated institutions from "making any changes or alterations to the monitoring program" "to avoid or minimise filing suspicious activity reports". Much criticism was directed at this provision, which, read literally, prohibited institutions from adjusting and refining their programs to eliminate false positives that otherwise would be the subject of suspicious activity reports. The final rule addresses DFS's concern in a more balanced fashion: "to the extent a Regulated Institution has identified areas, systems or processes that require material improvement, updating or redesign, the Regulated Institution shall document the identification and the remedial efforts planned and underway to address such areas, systems or processes".

The most closely watched provisions of the proposed rule, concerning the potential criminal liability of chief compliance officers, have undergone the greatest change. Section 504.4 no longer requires certification "by a "certifying senior officer" attesting to compliance with all substantive provisions of the rule. Instead, each regulated institution must adopt and submit a "board resolution" (or a "senior officer compliance finding") that, "to the best of its knowledge", the institution's transaction monitoring and filtering program "complies with all requirements of Section 504.3".

This revision may offer cold comfort to company boards but has apparently been received with some measure of relief in the compliance community, especially because many compliance officers considered the initial certification requirement to call for more knowledge and authority than they possessed. Section 504.5 of the rule, concerning "Penalties/Enforcement Actions", has also undergone an even more radical makeover; the original language has been deleted almost completely, including that sentence which formerly read: "A certifying senior officer who files an incorrect or false Annual Certification also may be subject to criminal penalties for such filing". In its place, the Section now reads in its entirety: "This regulation will be enforced pursuant to, and is not intended to limit, the Superintendent's authority under any applicable laws".

It is still too early to assess the financial industry's response to the final rule. It remains clear that the DFS intends to be an aggressive participant in an arena previously dominated by federal regulatory agencies. Financial Services Superintendent Maria T. Vullo stated as much in her forceful announcement of the final rule: "it is time to close the compliance gaps in our financial regulatory framework to shut down money laundering operations and eliminate potential channels that can be exploited by global terrorist networks and other criminal enterprises".

At the very least, however, the final rule reflects an acknowledgement that in a risk-based environment, institutions should be afforded some discretion to determine what is reasonable and applicable to their operations. And perhaps most notably, the rule takes a small step back from the alarming focus on personal liability of compliance officers that was the centrepiece of the proposed rule. Such a step is far more likely to ensure the committed participation of the compliance world than the menacing language which preceded it.

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CFTC ISSUES FINAL STAFF REPORT ON SWAP DEALER DE MINIMIS EXCEPTION

On 15 August 2016, the US Commodity Futures Trading Commission's (**CFTC**) Division of Swap Dealer and Intermediary Oversight published its Final Report addressing the *de minimis* exception to swap dealer registration (**Final Staff Report**). The Final Report supplements the Preliminary Report issued on 18 November 2015. Currently, during the initial phase-in period of the exception, a person is not deemed to be a swap dealer unless its swap dealing activities exceed an aggregate gross notional amount of US$8 billion over the prior 12-month period. On 31 December 2017, the phase-in period will end and the *de minimis* threshold will automatically decrease to US$3 billion, absent formal CFTC action.

The Final Report summarises, but does not respond to, public comments received in response to the Preliminary Report regarding the following alternatives to the current *de minimis* exception threshold:

(1) setting a higher or lower *de minimis* threshold;

(2) excluding from the threshold swaps traded on a swap execution facility (**SEF**) or a designated contract market (**DCM**) or cleared through a derivatives clearing organisation (**DCO**);

(3) factoring metrics such as the number of counterparties or transactions into the threshold determination (i.e. a multi-factor approach that includes notional value); and

(4) setting a notional *de minimis* threshold for each asset class.

The Final Report also describes further data analysis conducted by the CFTC in the interest rate swap (**IRS**), credit default swap (**CDS**), and non-financial commodity swap asset classes, and assesses how potential changes to the current US$8 billion threshold would affect the swap markets. With respect to the IRS and CDS asset classes, the Final Report found that "only a substantial increase or decrease in the *de minimis* threshold would have a significant impact on the amount of IRS and CDS activity covered by swap dealer regulation, as measured by notional amount, transactions, or unique counterparties". Furthermore, at the current US$8 billion threshold, the additional data analysis found that the vast majority

of IRS, CDS and non-financial commodity swap transactions involved at least one registered swap dealer (approximately 98%, 99%, and 89%, respectively).

The Final Report noted continued data limitations with respect to the reports submitted to swap data repositories (**SDR**), upon which the CFTC will base its final determination regarding the appropriate *de minimis* threshold. The Final Report makes no recommendation to the Commission regarding how to determine the *de minimis* threshold. Rather, it identifies three key issues for the Commission to consider in relation to the *de minimis* exception, namely whether to:

(i) allow the threshold to remain at the current US$8 billion level, allow it to fall to US$3 billion as scheduled, or delay the reduction until data quality improves;

(ii) exclude from the threshold calculation swaps traded on a SEF or DCM and/or cleared; and

(iii) re-examine the exclusion for swaps related to loans made by insured depository institutions.

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FINANCIAL CRIMES ENFORCEMENT NETWORK PROPOSES RULE REQUIRING AML PROGRAMS FOR BANKS LACKING A FEDERAL FUNCTIONAL REGULATOR

On 25 August 2016, the Treasury's Financial Crimes Enforcement Network (**FinCEN**) published a Notice of Proposed Rulemaking that would require anti-money laundering (**AML**) programs for banks that lack a federal functional regulator. Such banks include state-chartered, non-depository trust companies, non-FDIC-insured state banks and savings associations and non-NCUSIF-insured credit unions, private banks, and international banking entities that are not FDIC-insured but are authorised by Puerto Rico and the U.S. Virgin Islands to provide banking and other services to non-resident aliens.

For some time, such firms have had exemptions from certain AML program requirements, which in practice generated inconsistency and uncertainty with respect to exactly what is expected in terms of Bank Secrecy Act compliance and AML programs. FinCEN's proposed rulemaking confirms the expectation for these firms is consistent with traditional commercial or retail banks, and they must have an AML program inclusive of internal policies, procedures and controls, a designated compliance officer, ongoing employee training and independent audit of the program.

The rulemaking also applies customer due diligence (**CDD**) requirements to banks lacking a federal functional regulator, thereby requiring them to identify and verify the identity of customers and beneficial owners of customers that are legal entities (consistent with FinCEN's Final Rule published last May requiring CDD to be performed on individuals with direct or indirect ownership of 25% or more equity interest in legal entity customers, if any, as well as one control person for each legal entity customer).

FinCEN also welcomes public comments on the proposal. In particular, FinCEN is seeking comments on two key issues:

- Is the scope of the proposed rulemaking correct? More specifically, should any banks lacking federal functional regulators be excluded from the rule – presumably because they present little, if any, risk of money laundering and terrorist financing or have existing self-regulatory organisations which mandate AML requirements? Conversely, should other types of firms not listed also be included within the rule?
- Is the imposition of the same CDD requirements for these firms as currently applied to traditional banks appropriate in light of their customer relationships? If so, what time period is necessary for firms to implement these requirements?

Public comments are due by 24 October 2016.

Timing for any final rule on this proposal is unclear. In fact, it is noteworthy that the content and rationale for this proposal is generally consistent with a Notice of Proposed Rulemaking published by FinCEN in September 2015, extending Bank Secrecy Act compliance and AML requirements to registered investment advisers. That proposal has not yet been finalised. Because this proposed rule, as well as the prior one for registered investment advisers, clarifies regulatory expectations, however, we would advise clients to begin compliance efforts in anticipation of future finalisation of the rule.

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"SMART CONTRACTS" ON THE BLOCKCHAIN AND FINANCIAL TRANSACTIONS

Originally developed as the technology underpinning Bitcoin, blockchain has been heralded as an innovative technology with wide-ranging application beyond digital currency (or "cryptocurrency"), including as a platform for so-called "smart" contracts. Smart contracts are generally understood to be self-executing, autonomous computer protocols that facilitate, execute and enforce commercial agreements between two or more parties. As discussed below, blockchain-based smart contracts have enormous potential to streamline financial transactions and reduce the counterparty risk associated with monitoring or enforcing contractual obligations.

Blockchain technology refers to the use of a distributed, decentralised, immutable ledger for verifying and recording transactions. The technology enables parties to securely send, receive, and record value or information through a peer-to-peer network of computers. When parties wish to conduct a transaction on the blockchain, the proposed transaction is disseminated to the entire network. The transaction will only be recorded on a block once the network confirms the validity of the transaction based upon transactions recorded in all previous blocks. The resulting chain of blocks prevents third parties from manipulating the ledger and ensures that transactions are only recorded once.

Although the blockchain was developed to facilitate cryptocurrency transactions, entrepreneurs are now developing the technology for employing smart contracts. To develop a smart contract, the terms that make up a traditional contract are coded and uploaded to the blockchain, producing a decentralised smart contract that does not rely on a third party for recordkeeping or enforcement. Contractual clauses are automatically executed when pre-programed conditions are satisfied. This eliminates any ambiguity regarding the terms of the agreement and any disagreement concerning the existence of external dependencies.

One of the most important characteristics of the blockchain as it relates to smart contracts is the ability to enter into "trustless" transactions. Trustless transactions are transactions that can be validated, monitored and enforced bilaterally over a digital network without the need of a trusted, third-party intermediary. Multi-signature (or "multi-sig") functionality can be incorporated into smart contracts where the approval of two or more parties is required before some aspect of the contract can be executed (e.g., an escrow agreement between two parties and an escrow agent). Where a smart contract's conditions depend upon real world data (e.g., the price of a commodity future at a given time), agreed-upon outside systems called "oracles" can be developed to monitor and verify prices, performance, or other real world events.

Financial transactions are one potential use case for smart contracts. Smart derivatives contracts could be coded such that payment, clearing, and settlement occur automatically in a decentralised manner without the need for a third-party intermediary such as an exchange or clearing house. For example, a smart derivatives contract could be pre-programed with all contractual terms (i.e., quality, quantity, delivery) except for the price, which could be determined algorithmically from market data fed through an oracle.[1] Margin could be automatically transferred upon margin calls and the contract could terminate itself in the event of a counterparty default. The blockchain would perform the recordkeeping, auditing and custodial functions traditionally performed by intermediaries, resulting in transactional cost savings for the contracting parties.

With financial technology start-ups continuing to develop smart contracts for financial transactions, securities and derivatives regulators will ultimately need to formulate an approach for regulating their use. Several regulators have already signalled their intention to examine the use of blockchain technology in the financial sector. While smart contracts are potentially attractive to regulators since they increase transaction security and reduce the risk of manipulation, their implementation may raise difficult legal and regulatory challenges.

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US FINANCIAL REFORM AFTER SIX YEARS

Not long ago, the largest and most comprehensive financial reform law since the Great Depression turned six years old. The Wall Street Reform and Consumer Protection Act of 2010 (otherwise known as Dodd-Frank) became law on 21 July of that year. Now is a good time to consider how it has worked out.

[1] Houman B. Shadab, Written Statement to the Commodity Futures Trading Commission Global Markets Advisory Committee: Regulating Bitcoin and Block Chain Derivatives (Oct. 9, 2014), *available at* http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/gmac_100914_bitcoin.pdf.

(1) Dodd-Frank resulted from the lax financial laws that helped instigate the 2008 recession, the most terrible economic circumstances in 80 years. According to the Financial Crisis Inquiry Commission (**FCIC**), there were two causes which instigated the recession. First, asleep at the switch lawmakers and regulators who had little or no jurisdiction over dark markets (unregulated areas of finance where trillions are traded), and second, the captains of finance who took advantage of the unregulated environment. As a result, myriad new financial products – credit default swaps or CDSs, for example – were created, then used and in some circumstances abused. Some of the troublesome products were big bundles of mortgages, packaged and repackaged and traded in large lots. With billions of dollars based upon housing market wagers, when the housing market crashed, so did many financial firms which were over-leveraged with their risky gambles. This resulted in a US$620 billion US Government bailout of many large financial institutions (all told, 961 recipients) and the accompanying recession.

(2) All these years later, as a result of Dodd-Frank, there are greater capital, margin and clearing requirements on trading so that over-leveraging will not occur again. Furthermore there are new transparency requirements which enable regulators to see what is taking place. In addition, the new reform law took away authority to provide for another bailout. (Incidentally, the bailout money from 2008 has been repaid, with interest. The US Government actually made a profit of roughly US$69 billion.)

(3) Another positive outcome from Dodd-Frank is that the heretofore unsupervised financial products, and the trading venues are now overseen by regulators like the US Securities and Exchange Commission and the Commodity Futures Trading Commission. Moreover, other nations' financial watchdogs, which similarly had deficient laws, rules or regulations, are instituting appropriate safeguards. That is most important given that markets are connected across borders like never before.

(4) Dodd-Frank, despite some fits and starts in instituting the law, has worked rather well and the US financial sector is on a more solid footing because of it. That said, there are some in the US Congress, and US presidential candidate Donald Trump, who seek to repeal Dodd-Frank. Legislation in the US House of Representatives introduced on 9 September by Financial Services Committee Chairman Jeb Hensarling (Republican from Texas) to repeal Dodd-Frank is likely to move forward (albeit only in the House). The legislation, the CHOICE Act – Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs Act – would provide a "free pass" from many Dodd-Frank and Basel III capital and liquidity principles for banking establishments that choose to uphold extraordinary levels of capital. It would also retroactively rescind the power of the US Financial Stability Oversight Council to designate firms as systematically important financial institutions, and change the way the new US Consumer Financial Protection Bureau operates.

In the US Senate, Senate Banking Committee Chairman Richard Shelby (Republican of Alabama) has put forward a financial services reform package of his own, although there is no effort to move that legislation forward this year. The Senate majority could shift as a result of the November elections, thereby placing Senator Shelby in the minority and diminishing the possibility of any such reform.

For now, Dodd-Frank remains US law. Should Donald Trump win the presidential election and the Republicans retain control of the US Senate, it is likely that Dodd-Frank will be reviewed, if not replaced or repealed, in some fashion. Should Secretary Hillary Clinton win the election, Dodd-Frank will stay in place.

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NORWAY

ARE YOU COMPLIANT WITH THE NEW BOARD COMPOSITION REQUIREMENTS APPLICABLE TO NORWEGIAN FINANCIAL UNDERTAKINGS?

A new Act on Financial Undertakings and Financial Groups (Finansforetaksloven) (**Act**) was adopted in Norway on 10 April 2015 and entered into force on 1 January 2016. Pursuant to its transitional provisions, financial undertakings have one year to adapt to the new statutory requirements.

The Act replaces and compiles former institutional legislation for amongst others banks and credit institutions, as well as payment and e-money undertakings. Financial undertakings will have to identify what adaptations they must perform in order to become compliant with the new requirements by reviewing the composition of the board, controlling bodies and control functions, updating bye-laws and revising internal routines. Recently issued statutory regulations define the Act's transitionary regime.

As stated in the Act, the governing body of a financial undertaking is the board, the general assembly, a general manager and the controlling bodies. As of 1 January 2017, the board shall consist of at least five members representing all-round competence. Permission to form a board consisting of fewer members may be sought from the Norwegian Financial Supervision Authority (**NOR FSA**). Such approval, however, is usually reserved for small financial undertakings, including payment and e-money undertakings as well as minor pension funds.

A financial undertaking that is a subsidiary of a Norwegian financial group is required to appoint a board that consists of at least three members. Also, the chairman of the subsidiary may be an employee of the parent company. Note, however, that these exemptions do not apply to a Norwegian financial subsidiary of a foreign financial group. Also these Norwegian financial undertakings of foreign financial groups may apply for a dispensation from the NOR FSA.

The general manager cannot be a board member. Board positions may only to a limited degree be held by employees in the undertaking or in the financial group as applicable. The chairman of the board and at least two-thirds of the board shall not be employed in the undertaking or in any entity which forms part of the same financial group. It has not been clarified whether this prohibition also applies to working board members, however, not being employed in the undertaking. Alterations in the composition of the board shall be notified to the NOR FSA.

Employees' right to representation varies depending on the size and nature of the undertaking and, importantly, on whether there is a corporate assembly. In undertakings with 15 employees or more, employees may demand that one of them is to be appointed to the board. The same rule applies for all undertakings with corporate assemblies. Conversely, employees' right to representation is even greater if the undertaking in question has more than 50 employees but *lacks* a corporate assembly. In such cases, at least two board members must be employees, and employees may demand representation by as much as one-third of the board. This means that in undertakings of a certain size, employees' right to representation has been extended in comparison to what had been the case under previous legislation. The extended right to representation will also apply to a financial subsidiary, as long as its employees are not represented on the board of the parent company.

The Act introduces a broader information duty to the NOR FSA, including a requirement to document the suitability assessment relating to the board members and the general manager as well as other key employees.

Another amendment is that the board is obliged to hold quarterly meetings with their auditor, unless otherwise agreed in the board instruction. These meetings shall take place without the general manager being present, to ensure that the board is focused on uncovering any accounting omissions or fallacies.

The deadline for alignment with the new requirements is 1 January 2017.

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SPAIN

THE SPANISH RESOLUTION REGIME UNDER LAW 11/2015: THE ROLE OF THE RESOLUTION AUTHORITY AND STAY RIGHTS

This article describes certain elements of the Spanish Resolution Regime contained in Law 11/2015 and developing legislation which impact, generally, on financial transactions. Unless otherwise stated, the chapters, sections and articles referred to in this article refer to those contained in Law 11/2015.

The overall objective of the Spanish Resolution Regime is to restore and recapitalise an entity in resolution, where economically feasible. "Resolution" refers to one of the measures under Law 11/2015 which is consistent with the objectives of a resolution under the Bank Recovery and Resolution Directive 2014/59/EU.

The role of the Spanish resolution authority, the Fondo de Reestructuración Ordenada Bancaria (FROB)

The FROB, together with the Single Resolution Board where the entity is considered as significant and therefore subject to the Single Supervisory Mechanism, is the Spanish executive resolution authority. Law 11/2015 regulates, amongst other matters, its legal regime and status (article 1). Its characterisation as the executive (or executory) resolution authority derives from the definition of chapter VII section 1, and the distinction Law 11/2015 makes between the executive role, which is attributed to FROB, and the "preventive" resolution role, which is attributed to the Bank of Spain or the CNMV (the Comisión Nacional del Mercado de Valores), as applicable (which act as the supervisor/regulator of credit institutions, and securities broker dealers and related entities respectively).

The distinction between executive and preventive resolution authorities results from the principles under which the resolution process is structured. Under these principles, all entities subject to Law 11/2015 must adopt preventive measures to avoid executive resolution (through recovery plans and intra-group financial support). They should also establish, in a preventive fashion, resolution plans, under which the executive resolution authority will direct resolution once it is declared.

The FROB has ample powers and rights in both the preventive and executive phase of resolution.

Notably, in the preventive phase, FROB may:

- seek asset/liability valuations in respect of an entity and order such entity to engage in conversations with potential buyers with a view to preparing its resolution (article 11);
- issue prior reports in respect of resolution plans prepared by the preventive resolution authority in respect of single entities and group entities (article 13.1 and 14.1);
- request the update of resolution plans (article 13.3 (b));
- issue prior reports in respect of the assessment of resolvability or otherwise of an entity or group of entities and inform resolvability plans prepared by preventive resolution authorities (articles 15.1/2 and 16); and
- acknowledge impediments to resolvability upon review of reports issued by the preventive resolution authority in respect of single entities and group entities (articles 17 and 18).

The powers of FROB in the executive resolution phase are more direct: it acts with authority to guide and enforce the executive resolution process and the instruments of resolution provided for in Law 11/2015. Specifically:

- It will take notice/instruct the competent supervisor of the likelihood that an entity will enter into resolution (article 21.1)
- Determine whether a resolution measure is appropriate (article 19.1)
- Declare the initiation of the executive resolution phase (article 21.3) in respect of an entity and report to such effect to the Ministry of Economy, and the relevant preventive resolution authority
- Remove the management body of the entity (article 22) and approve the framework under which the special administrator appointed in respect of the entity in resolution will act (article 22.2)

- Implement the following resolution instruments: sale of business of the entity, transfer of assets or liabilities to a bridge entity, transfer of assets and liabilities to an asset management company, and bail-in (article 25.1/2)
- Carry out recapitalisation for entities in resolution (article 31 and ssq)

Support available in resolution procedures

The FROB can avail itself of financing to implement resolution plans. Such financing may be sourced: (i) on an ordinary basis from the National Resolution Fund where the entity is non-significant (article 31.1) (the financing for significant entities is sourced from the Single Resolution Fund in the context of the Single Resolution Mechanism); (ii) on an extraordinary basis from other sources (article 51.1); and (iii) by way of loans from other EU financing mechanisms. Alternative financing sources are also available where ordinary financing is not adequate to meet the required financing and extraordinary financing is not available. Such financing includes the issuance of fixed income securities, borrowing by way of loans or credit agreements and other indebtedness transactions (article 53.1 (a) and (b)).

The financing granted to the entity in resolution may take any of the following forms (article 53.2);

- Guarantees
- Loans, credit financing or other means of financing
- The acquisition of assets or liabilities
- Providing contributions to the bridge entity or to the asset management entity
- Payment of compensation to shareholders or creditors of the entity in resolution
- Contributions to the resolution entity when the resolution plan contemplates the exclusion of certain liabilities from bail-in
- Recapitalisation of the resolution entity

No worse-off principle

Creditors will receive no less than what they would have received in insolvency. This is the principle which runs throughout Law 11/2015 (articles 4.1 (a), (d). 5.3 paragraph 2, 53.7 (a)/(b)).

Executive resolution processes are based on certain guiding principles. As far as creditors are concerned, they are positioned before shareholders in the order of priority according to the rules of priority established in the insolvency law (Law 22/2003) (article 4.1 (b)) ("creditors will bear losses after shareholders […] in accordance with the rules of priority on insolvency"). In addition, Law 11/2015 provides that no creditor will suffer losses in excess of those which it would have suffered if the entity in resolution had been liquidated in an insolvency proceeding.

The no-worse off principle is also part of the valuation process of the entity in resolution required under Law 11/2015. Through valuation of the assets/liabilities, it aims to determine whether the conditions to implement resolution measures exist. Such valuation includes an assessment of the losses that had been incurred by shareholders and creditors, when the entity in resolution had been liquidated in the context of an insolvency procedure. The aim of establishing what would have been the outcome in a liquidation is to determine whether the conditions of resolution are satisfied and the application of resolution measures apply (article 5.3, second paragraph).

There are other instances where the treatment, which would have been afforded to creditors on insolvency, applies in resolution in respect of ranking. Specifically, loss absorption ranking in respect of guaranteed deposit funds should be the same as that which is applicable on insolvency (article 53.7 (a) and (b)).

Close-out Stay regime

There are specific provisions under the Spanish Resolution Regime that allow the relevant authority to temporarily or permanently stay or otherwise override contractual events of default with the entity in resolution (a "Close-out Stay").

(1) Permanent Stay

The adoption of a resolution measure, as well as the occurrence of any event related to the adoption of such resolution measure, will not of itself constitute an event of default and will not entitle the counterparty of the resolution entity to:

- Declare the early termination, suspension or amendment of contracts/transactions entered into with such entity
- Set-off in respect of rights or obligations which result from such contract/transaction
- Impact any way on such contractual relationship/transactions

Any contractual provision which entitles a party to a contract with an entity in resolution to exercise any of the above rights will be inapplicable/deemed as not having been entered into.

The right to call early termination may however be exercised upon an event of default occurring prior or post adoption of the relevant resolution measure, provided the termination event is not related to such measure having been adopted (article 66).

The same permanent stay would be applied to subsidiaries of the resolution entity, the obligations of which are guaranteed or otherwise supported by the resolution entity, or to contracts of any entity of the group of the resolution entity which include cross-default provisions.

This is a permanent stay on resolution related termination rights.

(2) Temporary Stay

The resolution authority may stay certain contractual rights for a period which can extend from the date the exercise of such stay right is published until midnight of following business day ("the Temporary Stay Period").

Contractual rights which may be subject to stay during the Temporary Stay Period are the following:

- any payment or delivery obligation arising under any contract entered into by the entity in resolution (article 70.1) and due in the applicable Temporary Stay Period;
- the enforcement of collateral guarantees in respect of assets of the entity in resolution (article 70.4) during the Temporary Stay Period; and
- the right to declare the early termination, resolution and rescission of any contract entered into by the entity in resolution or subsidiary of such entity if: (i) the resolution entity guarantees the subsidiary's payment obligation; (ii) the reason for termination is the parent's resolution or insolvency; or (iii) assets of the subsidiary may be transferred to a buyer or the resolution authority confers protection to such undertaking (article 70.5 and 70.6).

Any of the above rights may be exercised if the resolution authority notifies the counterparty, prior to the expiration of the Temporary Stay Period, that the assets and liabilities covered by the relevant contract will not be transferred to another entity, nor will be made subject to bail-in. If no stay is declared or if the resolution authority does not notify the counterparty of the "non-transfer of asset/liabilities"/"no bail-in measure" being applicable, the right to terminate, rescind or resolve the relevant contract may be exercised if any of the following applies:

(a) if the assets/liabilities have been transferred to "another entity", only when an event has occurred in respect of the recipient entity which gives rise to the right to terminate on "an ongoing basis" or thereafter (article 70.7 (a)), or

(b) if the entity in resolution remains the owner of the assets and liabilities and the FROB does not apply a bail-in tool when the stay period expires (article 70.7 (b)).

During such Temporary Close-out Stay:

(i) the implementation of any measures (i.e. early intervention or resolution) as well as any events occurring which are related to the adoption of such measures will not of themselves amount to an event of default and will not allow a counterparty to:

  - declare the termination, suspension or early resolution of the contract;
  - enforce any guarantee over the assets of the entity subject to such measures;

- carry out any available set-off in respect of rights or obligations arising out of the transaction or contract; or
- impact on such contract; and

(ii) any clause in a contract providing to any of such (above) effects will be deemed as not have been entered into.

Where a Temporary Stay Period applies, the resolution entity's counterparty's payment or delivery obligations will also be stayed for the same period (article 70.2).

Absent a stay, Law 11/2015 does not provide that, in the event of resolution, payment or delivery obligations are suspended.

Obligations under resolution or post-resolution of the entity in resolution or the transferee

Under article 66.1, paragraph 3, the right to terminate upon default exists if termination is not "necessarily" associated with the resolution (whether this is preventive or executive) measure. Article 66 only protects the resolution entity from events of default/termination rights. These are declared pursuant to contractual provisions which assimilate a resolution measure to an event of default or which consider such measures as insolvency type events. Law 11/2015 does not provide that the right to terminate is dis-applied, if a payment default occurs.

Therefore, the breach of payment obligations, to the extent such breach constitutes an event of default, will entitle the non-resolution counterparty to declare a termination event.

If all or substantially all of the assets of the entity in resolution are transferred by the administrative authority to a transferee, resolution-related default rights may be exercised in respect of any such agreements that are not transferred to such transferee.

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AUSTRALIA

RECENT REFORM: INTERCHANGE FEES

Throughout 2015 and 2016, the Reserve Bank of Australia (**RBA**) conducted a review of card payments regulation including extended consultation with stakeholders, including in relation to interchange fees in Australia. The review culminated in a Conclusions Paper, released in May 2016, and the publication of three new standards relating to interchange fees and surcharging. The new standards relating to interchange fees are Standard No. 1 of 2016 'The Setting of Interchange Fees in the Designated Credit Card Schemes and Net Payments to Issuers' and Standard No. 2 of 2016 'The Setting of Interchange Fees in the Designated Debit and Prepaid Card Schemes and Net Payments to Issuers'. The rationale behind the reforms was to improve the competitiveness of small-to-medium merchants as well as to provide greater clarity on the cost of payments for the different types of cards merchants accept.

The key decisions regarding the RBA's new interchange standards are:

- The weighted-average interchange fee benchmark for debit cards has been reduced to 8 cents per transaction, which will apply jointly to debit and prepaid cards in each scheme.
- The weighted-average benchmark of 0.50% for credit cards will be maintained.
- The weighted-average benchmarks will be supplemented by ceilings on individual interchange rates: 0.080% for credit; and 15 cents, or 0.20% if the interchange fee is specified in percentage terms, for debit and prepaid.
- Compliance with the benchmark will be observed quarterly rather than every three years.
- Commercial cards will continue to be included in the benchmark and will be subject to the ceilings.
- Transactions on foreign-issued cards acquired in Australia will remain outside the benchmark, in light of commitments from schemes to ensure that the Bank's standards are not circumvented.
- The new interchange benchmarks will take effect from 1 July 2017.

How the new standards operate: weighted benchmarks and ceilings

The weighted-average benchmarks remain the primary element of interchange regulation and will remain at 0.50% for credit cards. The weighted-average benchmark for debit cards will be lowered from 12 cents to 8 cents.

The weighted-average benchmarks will now be supplemented by caps on any individual interchange fee within a scheme's schedule. No credit card interchange fee will be permitted to exceed 0.80% and no debit interchange fee will be able to exceed 15 cents if levied as a fixed amount or 0.20% if levied as a percentage amount.

Do the new standards apply to commercial cards?

Yes. Although scheme providers and financial institutions submitted to the RBA that commercial credit cards should not be subject to the 0.80% on individual interchange categories, the RBA decided to include commercial cards within the ambit of the new standards. Commercial cards typically operate differently from personal cards in that the company holding the card is usually charged neither interest nor account fees, so interchange fees constitute a large share of the issuer's source of revenue. The RBA concluded that the benefits of corporate card programs fall mostly to the cardholder (for example, reporting and integration tools) and that accordingly the cost of these benefits should be borne by the cardholder and not the merchant.

Foreign-issued cards and anti-avoidance

The RBA decided against subjecting foreign-issued cards to the same regulations as transactions on domestically issued cards. The RBA did note that this may give rise to avoidance by issuing cards in a jurisdiction with a higher foreign interchange rate, but concluded that the concern about possible circumvention of domestic interchange caps by offshore issuance is tempered by commitments from the schemes that their scheme rules prevent such conduct.

Net payments

The new standards incorporate a concept of prohibiting a Net Payment to an issuer. The purpose of this prohibition is to prevent any circumvention of the interchange standards through payment of other types of fees.

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INTERNATIONAL

EU AND US ESTABLISH JOINT FINANCIAL REGULATORY FORUM

The European Commission (**EC**) issued a joint statement with the US Treasury dated 18 July 2016 on the renaming of the Financial Markets Regulatory Dialogue (**FMRD**) as the Joint Financial Regulatory Forum (**JFRF**) and improvements regarding US-EU co-operation regarding financial regulation. The joint statement was published following the first meeting of the JFRF, which is made up of US and EU participants, on 18-19 July 2016 in Washington D.C. The JFRF also published a second statement summarising the issues discussed during its first meeting.

The JFRF had been known as the FMRD for the previous 14 years and the change was decided so that the name better reflects the forum's activities in the post-crisis environment. The FMRD, reflecting the vision of Jonathan Hill to improve EU financial regulatory cooperation with the US, was established as a bilateral channel of co-operation in 2002.

The JFRF aims at improving transparency and compatibility of standards, reducing uncertainty and regulatory arbitrage, and identifying potential cross-border implementation issues. The JFRF will seek to identify and address unintended effects on financial markets deriving from the implementation of independent US and EU regulatory measures.

In order for the JFRF to act efficiently in addressing regulatory issues before they have an adverse effect on financial markets, both sides of the JFRF have agreed to consult each other at the earliest possible point during the rule-making process. The JFRF also intends to promote the domestic implementation of international regulatory standards in the financial sector; to share information on proposed new regulation, allowing for the timely identification of potential cross-border implementation issues; to discuss the respective scope, rules and processes of US substituted compliance and EU equivalence as well as their potential economic impact; to share data-driven economic and risk analysis; and to debate regulatory issues in a bilateral context as well as facilitate cooperation in multilateral context.

The JFRF will convene twice a year, allowing for additional technical meetings when necessary. Jacob J. Lew, Secretary of the Treasury, and Valdis Dombrovskis, Vice-President for the Euro and Social Dialogue and the person at the EU Commission in charge of Financial Stability, Financial Services and the Capital Markets Union, attended the first JFRF meeting. It is intended that the two shall meet once every year in order to discuss financial regulatory matters and ensure the proper functioning of the JFRF. Valdis Dombrovskis, during his speech at the Atlantic Council on 18 July 2016, referred to the JFRF as a chance to build on existing successes, such as the agreement on cross-border derivative regulation, and also associated the JFRF with potential further regulatory cooperation in the context of TTIP.

During the first JFRF meeting, participants focused on the following issues:

1. **Banking:** Participants discussed legislative and rule-making plans for the net stable funding ratio and the leverage ratio, and exchanged views on the upcoming steps required in order to finalise the international regulatory reform agenda in banking and discussed its potential impact.
2. **Bank Resolution:** Acknowledging that there had already been progress on cross-border bank resolution and profound cooperation between the EU and the US concerning technical aspects of resolution, the participants provided an update on their respective domestic implementation of the Financial Stability Board's international minimum standard relating to total loss absorbing capacity.
3. **Central Counterparty (CCP) Resolution:** CCP resolution was discussed in order to identify in advance respective approaches and potential cross-border considerations.
4. **OTC Derivatives:** The importance of ensuring the equivalence recognition of US swaps trading platforms under the EU's Markets in Financial Instruments framework was discussed. In addition, concerns were raised by the US participants regarding the delay of the EU in implementing the margin requirements for uncleared derivatives beyond the international deadline of 1 September 2016. The EU participants stated that the relevant technical standards would be issued as soon as possible.
5. **Funds:** ESMA reported that it would be issuing advice regarding the extension of the EU Alternative Investment Fund Managers Directive (**AIFMD**)

passport to US fund managers. Participants also discussed the recent clarification of the effect of the Volcker Rule on foreign private funds.

6. **Insurance:** Both EU and US participants supported the continuation of negotiations in a timely manner for a covered agreement on prudential insurance and re-insurance matters between the US and the EU.
7. **Audit:** The Public Company Accounting Oversight Board and the EC acknowledged the progress on transatlantic cooperation in audit oversight and the on-going efforts to define approaches to cooperation.
8. **Data Protection:** Support was expressed by the participants for data transfers between the EU and the US for regulatory, supervisory and enforcement purposes, particularly for regulatory oversight and the effective investigation and prosecution of misconduct.
9. **G20 Financial Regulatory Reforms:** Participants agreed on the goal of a stronger and more resilient financial system and recognised the importance of implementing the G20 financial regulatory reforms towards achieving that goal.

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IN FOCUS

FSB PROGRESS REPORT TO G20 ON ACTION PLAN ASSESSING AND ADDRESSING THE DECLINE IN CORRESPONDENT BANKING

On 25 August 2016, the Financial Stability Board (**FSB**) published its Progress Report to the G20 on the FSB action plan to assess and address the decline in corresponding banking.

The action plan was included in the report published in November 2015 by the FSB and focused on four points. The four elements raised by the FSB are: (1) further examining of the dimensions and implications of the withdrawal from correspondent banking; (2) clarifying regulatory expectations as a matter of priority; (3) domestic capacity-building in jurisdictions that are home to affected respondent banks; and (4) strengthening tools for due diligence by correspondent banks.

Given the important role that correspondent banking plays towards meeting the G20's goals for strong, sustainable and balanced growth, the international community is concerned about the impact of the decline in correspondent banking in sending and receiving international payments. In March 2016, FSB established a Correspondent Banking Coordination Group (**CBCG**) to coordinate and maintain momentum in the implementation of the action plan. CBCG comprises senior representatives from international organisations, standard setters and national authorities within the FSB framework and its Regional Consultative Groups.

The main conclusions of the Progress Report are:

1. CBCG has made progress implementing the FSB action plan. It identified that a deeper analysis of the causes and consequences of the decline is necessary and created a survey to address the remaining data gaps. Moreover, additional data and information will be needed in order to assess the concentration of correspondent banking in specific markets, as well as the changes in the structure of correspondent banking. It should be mentioned that the International Monetary Fund (**IMF**) has also published a staff discussion note on the need for further data collection and analysis, urging the presentation of evidence on a country-by-country basis.
2. CBCG proposed areas where regulatory expectations should be clarified, taking into consideration Financial Action Task Force (**FATF**) ongoing work, existing Basel Committee on Banking Supervision (**BCBS**) papers and the Committee on Payments and Market Infrastructure (**CPMI**) consultative review. CBCG created a list of these areas in order to support common understandings amongst relevant agencies, supervisory staff and banks, both nationally and internationally. FATF and/or BCBS will be responsible for the appropriate clarifications. To that end, FATF has made substantial progress towards issuing its guidance on the application of its standards to correspondent banking in October 2016 and BCBS will follow up with further clarification of its own existing guidance.
3. The FSB report of November 2015 observed that certain jurisdictions need to be supported in conducting risk assessments and developing effective AML/CFT frameworks. To achieve that goal and in order to help coordinate the available resources, CBCG established an inventory that identifies official sector technical assistance (**TA**) and other capacity-building activities. CBCG is also collecting additional information from other providers and has already created a list of public reports indicating potential TA needs in the future. CBCG is supporting private sector initiatives and is encouraging dialogue between the private and public sector.
4. CPMI issued the final version of its report on correspondent banking in July 2016. In order to encourage due diligence by correspondent banks, CPMI made recommendations regarding the use of "know you customer" utilities, the use of the Legal Entity Identifier in correspondent banking and information-sharing initiatives. The report also included payment messages on the correct use of methods of payment and described the potential public sector involvement in other technical solutions. The CPMI report notes that the increase in overall volumes of transfers is not inconsistent with the reported decline in the correspondent banking relationships, as payments are switched to other channels after account closures.

A more comprehensive report is expected by the end of 2016. The work under the action plan will continue in 2017 and changes in correspondent banking will be monitored, in order to assess whether the plan is having the intended impact.

The next JFRF meeting is scheduled for February 2017 in Brussels.

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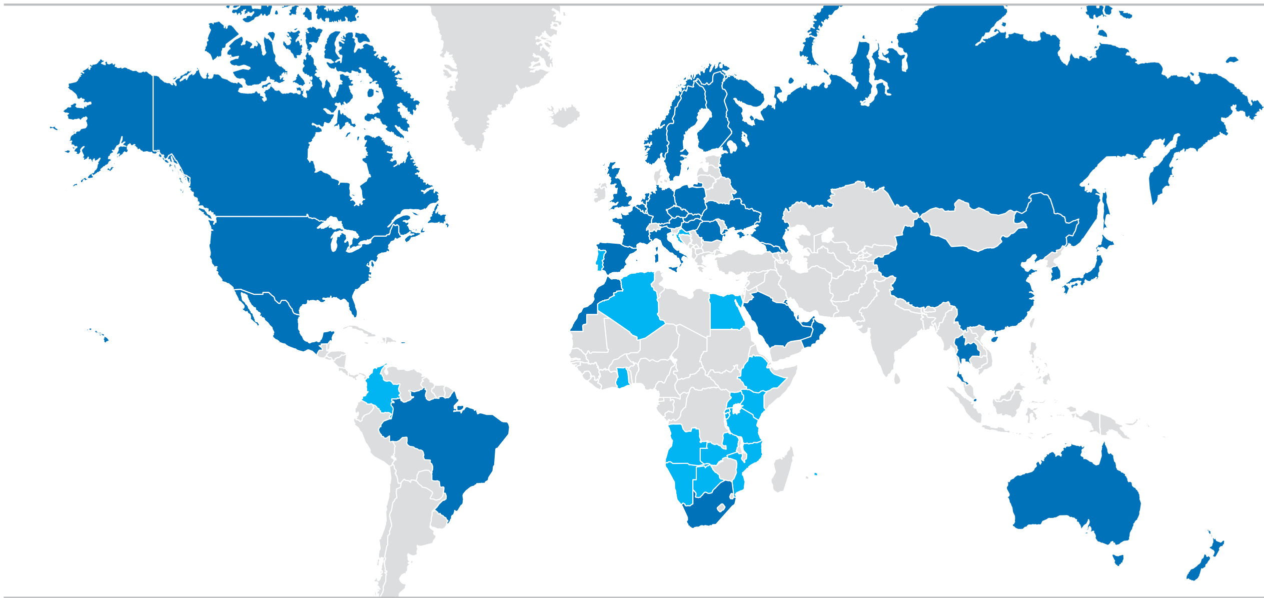

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