FINANCIAL SERVICES REGULATION
Exchange – International Newsletter

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DLA PIPER

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INTRODUCTION

WELCOME

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

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

In this edition, "In Focus" looks at the FCA's final rules on the segregation of client money by crowdfunding platform (P2P) operators and the new regulated activity of advising on P2P agreements.

In addition, we look at the delay to the MiFID II implementation deadline; the UK implementation of the Mortgage Credit Directive; and the new proposed Dutch laws on payment instrument surcharging.

Please click on the links below to access updates for each jurisdiction.

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

EUROPEAN UNION

MIFID II IMPLEMENTATION DATE DELAY CONFIRMED

On 7 April 2016, the European Parliament's Committee on Economic and Monetary Affairs (ECON) announced that it had voted in favour of the European Commission's proposal to delay the implementation deadline of the second Markets in Financial Instruments Directive (**MiFID II**) and the Markets in Financial Instruments Regulation (**MiFIR**) by a year, confirming that the new implementation deadline will be 3 January 2018.

In its original proposal to delay the MiFID II deadline, the European Commission cited technical challenges surrounding the implementation of MiFID II as necessitating the delay, noting that neither competent authorities nor market participants will have the necessary systems ready to implement the MiFID II package. In particular, the Commission acknowledged that the infrastructure necessary for trading venues to meet the reference data collection requirements contained in MiFID II would not be operational in time for the original implementation date.

Jonathan Hill, European Commissioner for Financial Services, Financial Stability and Capital Markets Union announced that in light of these exceptional circumstances and in order to avoid legal uncertainty and potential market disruption, an extension was deemed necessary.

Whilst the European Commission recognised that one possible approach would be to postpone the implementation date only in respect of those provisions of MiFID II that directly relate to data collection, for the sake of legal certainty, ECON voted in favour of an extension of the entire MiFID II package.

MARKET ABUSE REGULATION (MAR) – UPDATE

Regulation No. 596/2014 on market abuse (**MAR**) takes effect in the UK from 3 July 2016. This article provides an update of the actions taken by ESMA and the Commission leading up to the implementation of MAR.

ESMA consultation paper – 28 January 2016

On 28 January 2016, ESMA published a consultation paper on MAR draft guidelines. ESMA's proposed guidance in relation to persons receiving market soundings (**MSRs**) relate to the following matters:

- Designation of persons or a contact point within the MSR entitled to receive market soundings. It will be good practice for MSRs to evidence their designation decision and the way that that information is made available to the disclosing market participant (**DMP**).
- MSRs should notify the DMP whether it wishes to receive market soundings, and records of these notifications should be kept for five years.
- The MSR's own assessment as to whether it is in possession of inside information as a result of the market sounding and when they cease to be in possession of inside information. This should be an independent assessment taking into consideration all of the information available to the MSR, including information obtained from sources other than the DMP. Records of the assessment should be kept for five years.
- Discrepancies of opinion between DMPs and MSRs on whether inside information has been disclosed and when information ceases to be inside information. MSRs should refrain from informing the DMP of the difference in opinion if it is due to the fact that the MSR is in possession of information received from other sources, but inform the DMP if the assessment is based solely on information from the DMP.
- MSRs' obligation to report to competent authorities.
- Internal procedures to control the flow of information to be established and records to be kept for five years. Staff need to be trained.
- A list of wall-crossed staff should be drawn up and kept for five years.
- MSRs should carry out an assessment of related financial instruments and records kept for five years.
- MSRs should sign and agree (or provide their own version to the DMP) the written minutes or notes and recording of telephone calls prepared by the DMP.

ESMA also sets out its proposed guidelines on legitimate interests and omissions likely to mislead the public, in particular in relation to situations where:

- immediate disclosure of the inside information is likely to prejudice the issuer's legitimate interests (e.g. jeopardy of on-going negotiations of the issuer,

the financial viability of the issuer is in grave and imminent danger, and jeopardy of intellectual property rights of the issuer); and

- delay of disclosure of inside information is likely to mislead the public (e.g. material difference in the information intended to be delayed from a previous announcement or in contrast to market expectations).

Consultation on the draft guidance closed on 31 March 2016 and ESMA has stated that it will be publishing a report by early Q3 2016.

ESMA consultation paper – 30 March 2016

On 30 March 2016, ESMA published a consultation paper on draft guidelines relating to information expected, or required, to be disclosed on commodity derivatives markets or related spot markets under MAR. ESMA will consider all comments received by 20 May 2016 with a view to finalising the guidelines and publishing a final report by later in Q3 2016.

Under MAR, inside information in relation to commodity derivatives must: (i) relate to either the commodity derivatives themselves (whether directly or indirectly), or directly to the related spot commodity contract; (ii) be non-public, precise and likely to have a significant price effect if it were made public; and (iii) be reasonably expected to be disclosed by law.

However, given the wide variety of commodities markets and commodity derivatives markets, it may occasionally be necessary to distinguish between types of information specific to these markets. Therefore, ESMA is giving further consideration to the scope of the instruments or products concerned.

ESMA proposes examples for the three categories of information expected or required to be disclosed:

(a) **information relating directly to a commodity derivative** (e.g. information required to be published by trading venues and in relation to standardised commodity derivatives, information about exceptional circumstances such as a change to the fundamental characteristics of a standardised commodity derivative, or information relating to the market microstructure);

(b) **information relating indirectly to a commodity derivative** (e.g. in relation to commodity derivatives without a related spot market such as information expected to be disclosed by public entities, such as Eurostat or the ECB); and

(c) **information relating directly to a spot commodity contract** (e.g. information such as statistical information and with regards to wholesale energy products (electricity and gas), information required to be published under REMIT).

European Commission Delegated Regulations

The European Commission has to date adopted the following Delegated Regulations:

- 17 December 2015 – Delegated Regulation (C(2015) 8943) and two accompanying annexes covering:
  - the exemption for certain third countries' public bodies and central banks;
  - the indicators of market manipulation;
  - the disclosure thresholds;
  - the competent authority for notifications of delays;
  - the permission for trading during closed periods; and
  - types of notifiable managers' transactions.
- 26 February 2016 – RTSs on the criteria, procedure and requirements for establishing, maintaining, modifying and terminating an accepted market practice (AMP) (C(2016) 1087), together with an annex.
- 1 March 2016 – RTSs on the content of notifications to be submitted to competent authorities and the compilation, publication and maintenance of the list of notifications (C(2016) 1224), together with an annex.
- 8 March 2016 – RTSs relating to the conditions applicable to buy-back programmes and stabilisation measures (C(2016) 1357).
- 9 March 2016 – RTSs setting out the technical arrangements for the objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest (C(2016) 1403/F1).

Additional requirements apply when disseminating third-party recommendations, their summary/extract and any substantial alterations. Objective presentation involves ensuring that:

- o facts are clearly distinguished from other statements e.g. estimates or opinions;
- o substantially material sources are clearly indicated;
- o all sources of information are reliable (or clearly indicated if not);
- o all projections and associated presumptions are clearly labelled as such; and
- o the date and time of production of the recommendation is clearly indicated (and, if subsequently copied, the date and time of the first dissemination).

- 9 March 2016 – RTSs on the appropriate arrangements, systems and procedures, and notification templates to be used for preventing, detecting and reporting abusive practices or suspicious orders or transactions (C(2016) 1403) and a related annex.

Implementing measures published in the Official Journal of the EU

The following implementing measures have to date been published in the Official Journal of the EU and will take effect from 3 July 2016:

- 18 December 2015 – Implementing Directive relating to the reporting to competent authorities of actual or potential infringements ((EU) 2015/2392).
- 11 March 2016 – Implementing Regulation laying down ITSs with regard to the precise format of insider lists and for updating insider lists in accordance with the Market Abuse Regulation ((EU) 2016/347).
- 5 April 2016 – Implementing Regulation ((EU) 2016/523) laying down ITSs with regard to the format and template for notification and public disclosure of managers' transactions in accordance with MAR. The annex to the Implementing Regulation contains a template that must be used for notifying managers' transactions.

JOINT COMMITTEE OF ESAS PUBLISHES FINAL DRAFT RTSS ON RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVE CONTRACTS NOT CLEARED BY A CCP UNDER EMIR

On 8 March 2016, the Joint Committee of the European Supervisory Authorities (**ESAs**) published the final draft regulatory technical standards (**RTSs**) on risk-mitigation techniques for over-the-counter (**OTC**) derivative contracts not cleared by a central counterparty (**CCP**) under Article 11(15) of the European Market Infrastructure Regulation (**EMIR**). EMIR aims to increase the stability of the OTC derivative markets in the EU.

Mandate

EMIR sets out provisions aimed at increasing the stability and transparency of the OTC derivatives markets and requires certain classes of OTC derivative contracts to be cleared, derivative transactions to be reported to trade repositories, and the establishment of a framework for the registration and supervision of CCPs. EMIR came into force on 16 August 2012. In respect of OTC derivatives not subject to the clearing obligation, EMIR prescribes a requirement for financial counterparties and, with respect to OTC derivative contracts that are entered into once the clearing threshold is exceeded, non-financial counterparties, to have in place risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral. There are a number of exemptions for intragroup transactions, most of which require approval from the relevant competent authorities.

The final draft RTSs have been drafted by the ESAs as required by Article 11(15) of EMIR and will be submitted to the Commission for adoption. The RTSs contain provisions on:

1. the risk-management procedures relating to exchange of collateral in respect of non-centrally cleared OTC derivatives;
2. the procedures for counterparties and competent authorities to follow in respect of persons seeking to rely on those of the intragroup exemptions from the requirement to establish the above risk-management procedures which require competent authority approval; and

3. the criteria for the identification of practical or legal impediments to the prompt transfer of funds between intragroup counterparties (EMIR requires that the intragroup exemptions shall not be relied upon where such impediment exists).

The RTSs follow the framework established by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO), and the BCBS supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, while taking into account the specific features of the European derivatives market.

Margin models

To reduce counterparty credit risk, mitigate systemic risk and ensure alignment with international BCBS-IOSCO standards, counterparties must exchange both initial and variation margins for OTC derivatives not cleared by a CCP. The draft RTSs prescribe that counterparties may use one of two approaches when calculating initial margin requirements. Counterparties may utilise the standardised approach, which mirrors the mark-to-market method set out in Articles 274 and 298 of Regulation (EU) No 575/2013 (Capital Requirement Regulation). Alternatively, counterparties may use a different margin model, provided it complies with the detailed requirements set out in the RTSs. Such a model must assume the maximum variations in the value of the netting set at a confidence level of 99% with a risk horizon of at least ten days. Models must be calibrated on an historical period of at least three years, including a period of financial stress, and observations from the period of stress must represent at least 25% of the data.

Eligible collateral

A list of eligible collateral for the exchange of margins is set out along with the obligation to ensure that collateral is sufficiently diversified and not subject to wrong-way risk. The RTSs also outline the methods for determining appropriate collateral haircuts.

Assets deemed eligible for margining purposes should be:

- sufficiently liquid;
- not exposed to excessive credit, market and foreign exchange risk;
- able to hold their value in times of financial stress;
- in terms of value, not exhibit a significant positive correlation with the creditworthiness of the counterparty (wrong way risk); and
- sufficiently diversified.

To the extent that the value of the collateral is exposed to market and foreign exchange risk, risk-sensitive haircuts should be applied. The RTSs allow the use of either standardised haircuts or internal models for the calculation of haircuts.

A set of operational requirements is included in the RTSs to ensure that counterparties have the capability to properly record the collected collateral and manage the collateral in the event of counterparty default. Various reporting and record keeping obligations for derivatives counterparties are introduced by the RTSs to meet these requirements.

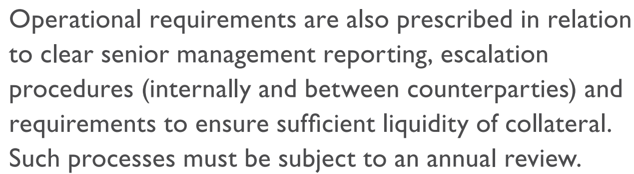
To ensure that collected collateral is of sufficient credit quality, the RTSs introduce mitigants against an excessive reliance on external ratings. The use of either internal or external credit assessments remain subject to a minimum level of credit quality. Parties to a derivatives contract can either agree to the use of an internal-ratings based **(IRB)** approach from credit institutions authorised under the CRR or, failing this, define a list of eligible collateral relying on the external credit assessments of recognised credit assessment institutions.

The RTSs addressed the risk of a ratings downgrade possibly triggering a market sell-off of collateral by introducing a grace-period following a downgrade, whereby counterparties must follow a well-defined process to replace collateral following a credit rating downgrade.

To prevent wrong-way risk, the RTSs do not allow own-issued securities to be eligible collateral, except on sovereign debt securities.

Operational processes

Counterparties are required to implement robust operational procedures to ensure appropriate risk-management. The RTSs set out operational procedures related to documentation between counterparties and internally, legal assessments of the enforceability of the agreements and the timing of the collateral exchange.



Operational requirements are also prescribed in relation to clear senior management reporting, escalation procedures (internally and between counterparties) and requirements to ensure sufficient liquidity of collateral. Such processes must be subject to an annual review.

Intragroup derivative contracts

Intragroup derivatives transactions can be exempted by competent authorities from the requirement to exchange collateral. To ensure a uniform approach across EU Member States, a clear procedure is established in relation to the amount of time that competent authorities have to grant approval for exemption or to make an objection, the information to be provided to the applicant and a number of other risk-management obligations placed on the counterparties.

Implementation

The draft RTSs acknowledge that a specific treatment of certain products may be appropriate. This includes, for example, physically settled foreign exchange swaps, which need not be subject to initial margin requirements.

It is anticipated that the RTSs will enter into force on 1 September 2016, subject to endorsement by the European Commission. The initial margin requirements will be phased in over a period of four years and will initially only apply to large market participants.

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

UNITED KINGDOM

UK REGULATORY DEVELOPMENTS

FCA AND PSR CONSULT ON CHANGES TO THE PAYMENT ACCOUNTS FRAMEWORK

FCA CONSULTATION PAPER CP16/7

On 2 March 2016, the FCA published a consultation paper (*CP16/7: Payment Accounts Regulations 2015 – draft Handbook changes and draft guidance)* with draft guidance and proposed changes to its Handbook relating to requirements imposed by the Payment Accounts Regulations (**PARs**) that were passed in December 2015.

The PARs implement the EU Payment Accounts Directive (*2014/92/EU*). The provisions on account switching, payment accounts with basic features, and packaged accounts will take effect on 18 September 2016 and the changes to be made to the FCA Handbook to reflect these provisions must be incorporated before that date. Given the short period of time between the consultation paper and the implementation date, the FCA intends in the first instance to introduce only those changes to the Handbook that are strictly necessary to ensure the compatibility of the Handbook with the PARs. Further work may be required at a later date. The FCA is also consulting on proposed non-Handbook guidance to assist payment service providers (**PSPs**) with the implementation of certain aspects of the PARs. The draft proposals are set out below.

Definition of payment account

The consultation paper sets out the FCA's proposals to issue guidance on the definition of a 'payment account' for the purposes of the PARs to reduce the risk of PSPs interpreting it too narrowly. The draft guidance is set out at appendix 2 to the consultation paper. This guidance distinguishes the definition of *payment account* for the purposes of the PARs from the definition of *payment account* for the purposes of the Payment Services Regulations 2009. The definition under the PARs is narrower and, in summary, only includes accounts in which consumers are able to place funds, withdraw cash, and execute and receive payments to and from third parties, including the execution of credit transfers. Whilst savings accounts, credit card accounts where funds are usually paid for the sole purpose of repaying a credit card debt, current account mortgages and e-money accounts do not normally amount to *payment accounts,* they can amount to such where they are used for day-to-day transactions. The draft guidance sets out some examples of accounts that are likely to be in or out of scope in the view of the FCA and outlines the FCA's expectations regarding reassessing the nature of an account following its original categorisation.

Implementation of the provisions regarding packaged accounts

Furthermore, the FCA proposes to issue guidance on the implementation of the provisions on packaged accounts which are set out in regulation 13 of the PARs. Regulation 13 prescribes that where a payment account is offered as part of a package with another product or service which is not linked to a payment account (e.g. insurance products), the PSP must inform the consumer whether it is possible to purchase the payment account from it separately and, where this is the case, information regarding the costs and fees associated with each of the other products and services offered in the package that can be purchased separately from the PSP.

In the draft guidance, the FCA clarifies that it expects PSPs not to take an unduly narrow approach to assessing whether or not an account is available separately. In particular, the terms and conditions of the account available separately need not be identical to those of an account offered as part of a package.

The FCA explains that a suitable approach would be to determine whether a consumer would consider that the most important features of the two products are the same. Where other products offered as part of the package that includes a *payment account* that is available separately from a PSP are also available separately from that PSP, the guidance suggests that PSPs will be under an obligation to provide details of the costs of all of those other products.

Rule 6 of the Insurance Conduct of Business Sourcebook (**ICOBS**) outlines disclosure requirements for insurance products offered as part of a package. There is currently an exemption that applies to those disclosure requirements where insurance products are offered as part of a package that includes a packaged bank account. The FCA does not intend for this exemption to trump the provisions of the PARs and, as such, sets out proposed changes to the ICOBS exemption to direct PSPs' attention to the disclosure requirements contained in regulation 13 of the PARs.

Handbook changes in relation to account switching

The current FCA Handbook provisions relating to switching consumer bank accounts are contained in the Banking Code of Business Sourcebook (**BCOBS**). In light of the provisions of the PARs, the position is more detailed in relation to the duties and responsibilities of transferring and receiving PSPs than is envisaged in relation to the retail banking services provided for in BCOBS. As a result, the FCA sets out that BCOBS is to be amended to:

- signpost firms to the switching provisions of the PARs;
- disapply certain guidance provisions when the account switching provisions of the PARs apply; and
- delete the reference to the European Banking Industry Committee Common Principles for Bank Account Switching, which have been superseded by the PAD.

Regulatory reporting

The proposals also include new regulatory reporting requirements in relation to switching and payment accounts with basic features to be set out in chapter 16 of the Supervision Manual (SUP) to ensure compliance with transparency requirements. The FCA proposes that PSPs are required to report two data items: the number of payment accounts that have been switched, and the proportion of switching applications that have been refused. In addition, credit institutions offering payment accounts with basic features will be required to report two further data items: the number of payment accounts with basic features that have been opened, and the proportion of applications for payment accounts with basic features that have been refused.

This data shall be submitted on a new regulatory reporting form appended to the consultation by all PSPs offering payment accounts within the meaning of the PARs by 30 April 2018. The FCA initially proposes for the reports to be submitted every two years, but notes that this is subject to change.

Enforcement aspects

The FCA also proposes to update the Decision Procedures and Penalties Manual (DEPP) and Enforcement Guide (EG) to reflect the FCA's powers of enforcement under the PARs.

The FCA is seeking responses to the consultation by 3 May 2016 and intends to publish its final Handbook provisions in summer 2016 in order to maximise the time available to PSPs to take any action needed.

PSR CONSULTATION PAPER CP16/1

On 15 March 2016, the Payment Systems Regulator (**PSR**) published a consultation paper (*CP16/1: The application of the Payment Accounts Regulations 2015 in respect of alternative arrangements of switching accounts*) regarding alternative arrangements for switching accounts. While the FCA is responsible under the PARs to ensure that PSPs offer a switching service to their customers, the PSR is appointed by HM Treasury as the designated authority for designating alternative switching services and monitoring compliance with the designation criteria.

Alternative Switching Services constitute any scheme that meets the following criteria and is designated as such by the PSR. The criteria are that the scheme:

1. is clearly in the interests of the consumer;
2. does not impose any additional burdens on the consumer additional to those imposed on the consumer by the PARs; and
3. ensures that the procedure for switching is completed at least within the same overall timeframe (12 business days) that applies in the case of a switching service that is PAR-compliant.

The draft guidance describes the PSR's proposed approach to designating alternative switching schemes, the proposed monitoring process and how the PSR intends to use its enforcement powers. This includes the PSR's approach to evaluating an application for designation as an alternative switching scheme and the application process to become an alternative switching scheme itself.

The PSR also sets out its proposals in relation to regulatory fees relating to the PARs. Fees relating to funding of the PSR's activities will be recovered from operators of alternative switching schemes. For the year 2016/17 the PSR proposes a one-off application fee of £5,000 and an annual fee of £12,000.

The opportunity to provide comments in response to the consultation closed on 12 April 2016. The PSR will issue its final approach at the same time as the FCA, in summer 2016, after assessing any applications for determination.

UK IMPLEMENTATION OF MORTGAGE CREDIT DIRECTIVE

On 21 March 2016, the Mortgage Credit Directive (2014/17/EU) (**MCD**) was transposed into UK law through amendments to the Regulated Activities Order by the Mortgage Credit Directive Order 2015 (SI 2015/910) (**MCD Order**) and the FCA's Mortgages and Home Finance Conduct of Business sourcebook (**MCOB**).

The MCD introduced changes in the following areas: assessing affordability, minimum standards in the provision of advice, product disclosure (through a requirement to provide a *European standard information sheet* (ESIS) by 21 March 2019) and staff training. The MCD also prescribes maximum harmonising standards in relation to annual percentage rate of charge (APRC). Therefore, MCOB now contains two sections on the calculation of the APRC/APR – firms will need to identify if the loan is covered by MCD and apply the appropriate calculation.

The MCD also widens the scope of the UK mortgage regulation regime to include second charge mortgages (**SCM**) and consumer buy-to-let mortgages (**CBTL**). In view of these changes, firms undertaking mortgage activities should review their existing mortgage permission profile to ensure that they hold the correct permissions and authorisations for SCM and/or CBTL.

Changes to regulation of second charge mortgages

Regulation of SCMs will move from the consumer credit regime to the mortgage regime. Firms already holding Part 4A permissions for regulated mortgage contracts will not need to apply to vary their permission in order to carry out second charge mortgage activities post-MCD.

The FCA has applied most elements of its existing mortgage regime to second charge mortgages. For example, the MCOB disclosure requirements and affordability rules will apply to SCMs. Execution-only sales are also only allowed in limited circumstances and SCM advisors have until 21 September 2018 to obtain the relevant competency qualifications.

Second charge lenders need to submit aggregate data via the mortgage lenders and administrators return, retail mediation activities return from 21 March 2016 and submit product sales data from 1 April 2017. There are currently no prudential requirements for SCM firms until further assessment by the FCA to be carried out by March 2017.

Administrators of SCMs that existed before 21 March 2016 will now be subject to most of the conduct requirements of MCOB rather than the provisions of the FCA's Consumer Credit Sourcebook (**CONC**). However, as pre 21 March 2016 SCMs are not subject to the provisions of the MCD, the MCOB conduct rules stated as applying to *MCD regulated mortgage contracts* will not apply to these back-book SCMs.

Changes to regulation of consumer buy-to-let mortgages

The UK government opted to exempt consumer buy-to-let lending from the detailed requirements of the MCD and put in place an alternative *appropriate framework* for the regulation of such mortgages. This framework (including a set of conduct standards) is set out in Part 3 of the MCD Order and constitutes a new regime for CBTL. It should be noted that the FCA does not have the power to amend these conduct standards. Non-consumer buy-to-let mortgages will not be subject to this new regime.

Under the new regime, CBTL lenders, administrators, intermediaries, arrangers and advisers (except where the borrower is acting wholly or predominantly for the purpose of business) need to be registered with the FCA to carry on such activities and be subject to the conduct standards set out in Schedule 2 of the MCD Order 2015. The government has adopted a broad definition of *acting wholly or predominantly for the purpose of a business* which excludes a wide range of borrowing which might otherwise be subject to the new CBTL regime. *Consumer landlords*, e.g. those who have inherited the properties and those who have previously lived in the properties but are unable to sell and resort to a buy-to-let arrangement will not be considered as acting for the purpose of business and therefore afforded the protections under the CBTL regime.

FCA RULES ON DISCLOSURES TO CONSUMERS BY NON-RING FENCED BODIES

On 24 March 2016, the FCA published a policy statement (*PS16/9: Ring-fencing: disclosures to consumers by non-ring-fenced bodies*) which outlines its near-final rules on disclosures that deposit-taking non-ring-fenced bodies (**NRFB**) must make to consumers. NRFBs are the non-ring fenced banks within a group which includes a ring-fenced bank. The policy statement follows-on from the 14 July 2015 consultation paper (*CP15/23: Ring-fencing: disclosures to consumers by non-ring-fenced bodies*) that sets out the draft rules relating to these disclosures. After positive feedback received during the consultation, the FCA has decided to implement the rules for the most part as originally proposed.

The rules form part of the ring-fencing regime that will be implemented by the UK government from 1 January 2019. The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (**Order**) requires the FCA to make rules specifying the information that an NRFB deposit-taker must provide to both individuals that apply to open a new account with that NRFB, and also to existing individual account-holders. Banking groups are required by FSMA to ring-fence their core activities so that ring-fenced bodies are protected against adverse disruptions in their groups or in the wider financial system.

Overall approach

The FCA is obliged to produce rules to provide for the disclosure of relevant information to individuals who are, or seek to become account holders with NRFBs. The proposed rules address this obligation and exceed the minimum requirements of the Order, requiring NRFBs to provide the information before they become NRFBs, provide contextual information in addition to that specified in the Order and publish the information on their website.

Some respondents to the consultation suggested that the provisions should also apply to banks that are not subject to the ring-fencing regime but undertake the broader range of activities open to NRFBs, however the FCA has not adopted this approach.

Content of disclosure

The content requirements for the NRFB disclosure are twofold.

First, NRFBs will be required to provide consumers with an overview contextual narrative that helps them understand the implications of banking with an NRFB in a banking group with a ring-fenced bank (**RFB**). This narrative should state that the purpose of ring-fencing is to insulate RFBs from certain financial risks, and that the significance of not being ring-fenced is being allowed to run risks to which a ring-fenced bank would not be allowed to expose itself.

Second, the NRFB should outline in high-level overview terms any excluded activity the NRFB is carrying on and any *prohibited action* (actions prohibited for an RFB, but permitted for an NRFB) that the NRFB has taken.

Some respondents to the original consultation suggested that these provisions are overly prescriptive, however the FCA has stated its intention to proceed with the rules as proposed. In justifying this approach, particular emphasis is placed on the fact that the information provided should only be set out in high-level, non-exhaustive terms. The FCA reiterates that its proposed rules reflect the requirements laid down by the Order.

Recipients of disclosure

Individuals with, on average, financial assets of at least £250,000 will be permitted to hold accounts with NRFBs. Where such an individual declares himself to be eligible to the NRFB, the NRFB must provide the above information to them.

NRFBs shall provide the information to any potential customer who applies to open an account and to individuals who were account holders at the time the institution became an NRFB.

There will be no obligation to provide the disclosure to other categories of depositors (medium – or large-sized companies and financial institutions) as those categories of depositors are likely to have access to their own financial and legal advice.

Timing and format of disclosure

The disclosure must be made to individuals that an NRFB anticipates will become eligible to hold an account with the NRFB and in good time to enable them to make an informed choice about where they deposit their money. The FCA states that in many cases this will be before the institution becomes an NRFB.

In its responses to certain questions raised in the consultation period, the FCA clarifies that NRFBs must send the information to individuals from when the NRFB contemplates it is likely to receive a declaration of eligibility.

In terms of the format of the disclosure, the rules provide that the information must be communicated:

- in writing;
- in a manner and via a channel that ensures that the document and its content are likely to come to the attention of the individual to whom it is addressed;
- in language that is clear, fair, not misleading and intelligible, having regard to the category of consumers to which it is addressed; and
- by publication on the NRFB's website alongside the written disclosure.

If the NRFB does not have any relevant customers within its client base, it is not under an obligation to send information to individuals or publish such information on its website.

Next Steps

The FCA chose to publish a near-final version, rather than a final version, of the rules to ensure that banks have enough time to make themselves aware of their obligations before they implement the ring-fencing transfer schemes. The FCA intends to bring the final rules into force later in 2016, however the FCA states that the final rules will not affect banks until the period immediately preceding their own structural separation.

FCA AND HM TREASURY PUBLISH FINAL JOINT REPORT ON THE FINANCIAL ADVICE MARKET REVIEW

The Financial Advice Market Review (**FAMR**) was launched in August 2015 to examine how financial advice could operate better for consumers. This is set against the background of the increasing need for individuals to take more responsibility for their own financial future. A wide range of stakeholders, representing both industry (including large and small financial advice providers) and consumers responded to a public Call for Input in October 2015. HM Treasury and the FCA published a joint final report on 14 March 2016 (**Report**) which focuses on three key areas: (i) affordability, (ii) accessibility, and (iii) liabilities and consumer redress. The Report sets out a number of recommendations for each area.

NEXT STEPS/IMPLEMENTATION

A Finance Advice Working Group comprising of members of the FAMR Expert Advisory Panel, members of the FCA Consumer Practitioner and members of the Smaller Business Practitioner Panels will be formed and tasked with publishing a list of new terms to describe what constitutes *guidance* and *advice*.

FAMR proposes that the FCA and HMT jointly report their progress to the Economic Secretary and FCA Board in 12 months and review the outcomes of FAMR in 2019.

In the next 12 months the FCA and HMT are tasked with developing appropriate baseline indicators to monitor development of the advice market.

Affordability

The Report noted that the market currently delivers high quality solutions to those who can afford advice, but the provision of advice and guidance to the mass market needs to be more cost effective.

The key recommendations are as follows:

- The definition of "regulated advice" in the Regulated Activities Order should be narrowed to reflect the position under the Markets in Financial Instruments Directive (**MiFID**) i.e. based around personal recommendations. Currently, consumer financial advice is often engineered to stop a safe distance short of what the adviser perceives to be regulated advice. The FAMR hopes that narrowing the definition will mitigate firms' reluctance to offer other, potentially less expensive, support to consumers in the form of helpful guidance, for fear of straying into the provision of advice.
- The FCA should develop a more transparent advice framework with new guidance to support firms who provide streamlined advice and offer services that help consumers to make their own investment decisions. This should include illustrative case studies and could potentially involve modifying time limits for a firm's employees to qualify under the FCA's Training and Competence sourcebook.
- When transposing MiFID II, HMT should ensure that the FCA's ability to implement proposals to deliver such streamlined advice is not undermined.
- The FCA and industry should work to improve suitability reports, namely reducing their length and preparation time.
- The FCA should build on the success of Project Innovate and set up a dedicated advice unit to help firms to develop mass-market automated advice models. The FAMR envisages such models to be particularly beneficial for commodity-type financial advice, such as diversifying from investing in single asset classes or highlighting persistent underperformance of particular investments.

Accessibility

Many consumers with lower income or investible amounts are unable or unwilling to pay for advice. Respondents suggested that a number of consumers felt that financial advice is "not for them" and have a lack of trust in advisers. The key recommendations aimed to improve accessibility to financial advice are as follows:

- The FCA and Pensions Regulator should develop a factsheet setting out what financial advice employers and trustees can provide without being subject to regulation (and provide incentives for giving such advice). This could include helping employers develop a guide to the top ten ways to support employees' financial health.
- HMT should explore options to improve the £150 income tax/NI exemption for employer-arranged advice on pensions.
- HMT should challenge industry to create a pensions dashboard by 2019. This would enable consumers to easily access information on any pension pots they have accumulated over their working life.
- Employees could also have an option to redeem a small portion of their pension pot against the cost of pre-retirement advice before pensionable age; what qualifies as *small* has not been proposed.
- Nudges could be introduced at key life stages to encourage consumers to seek financial advice and general rules of thumb could provide simple principles which are generally reliable in the absence of full advice. HMT should assign the continuing responsibility for maintaining and reviewing such nudges to an appropriate body with financial capability expertise.

Liabilities and consumer redress

The Report stressed the importance of consumer protection in building confidence in the financial sector; consumers should have access to redress if they are wrongly advised. However, this should be balanced with the need to give firms confidence that they will not be exposed to unquantifiable future costs. The recommendations are as follows:

- The 2016 FSCS Funding Review should explore risk-based levies, reform the FSCS's funding classes and consider whether contributions from firms could be smoothed by making more effective use of the available credit facility. Following which, the FCA should consider whether a review of professional indemnity insurance cover for smaller advice firms is necessary.

- The FOS should consider undertaking *best practice* roundtables with industry and trade bodies, publishing additional data on its uphold rates, establishing a more visible central area for firms on its website by summer 2016, and assessing whether its Independent Assessor Report should contain a more in-depth analysis of potential areas for process improvement from 2017.
- Despite feedback from respondents, the Report states that a longstop date on complaints to the FOS would not be in the interests of consumers. This topic will be re-visited in 2019.

PRA SETS OUT PROPOSALS TO AMEND ITS RULES ON THE CONTRACTUAL RECOGNITION OF BAIL-INS

On 15 March 2016, the PRA published a consultation paper (*CP8/16: The contractual recognition of bail-in: amendments to Prudential Regulation Authority rules*) setting out proposed amendments to the PRA Rulebook and a draft supervisory statement regarding the contractual recognition of the bail-in tool which was introduced by the Bank Recovery and Resolution Directive (2014/59/EU) (**BRRD**).

The current rules

The current PRA rules on contractual recognition of the bail-in tool ensure that BRRD firms (Credit institutions and investment firms, as defined in the CRR, that are subject to an initial capital requirement of EUR 730,000 under Article 28(2) of the CRD IV Directive) include a term in non-EU law contracts governing liabilities by which the creditor recognises that the liability may be bailed-in by the Bank of England as the resolution authority. These rules implement Article 55 of BRRD. The PRA considers that the broad scope of the current rules makes compliance impracticable in some circumstances. In November 2015, the PRA published a modification by consent which disapplies the rules in circumstances where compliance with them in respect of *phase 2* liabilities (liabilities under the scope of BRRD other than unsecured debt instruments, additional tier 1 instruments and tier 2 instruments) is impracticable and where firms have notified the PRA. The modification was introduced to apply until the consultation process envisaged by CP8/16 is concluded and will expire on 30 June 2016.

Amendments to the rules

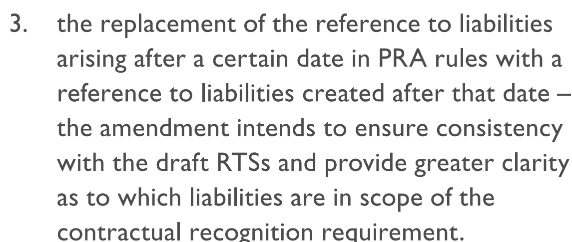
The consultation paper contains new proposals extending the modification to the bail-in requirements. More specifically, the PRA proposes to amend its rules to disapply the contractual recognition requirement for phase 2 liabilities, where the inclusion of such language is *impracticable*.

The PRA expects BRRD firms to make a *reasoned assessment* as to whether the inclusion of such language is "impracticable" in relation to a particular phase 2 liability. The supervisory statement that appears at Appendix 2 to the consultation paper sets out a range of circumstances where this may be the case. For example, BRRD firms may regard the inclusion of such wording to be impracticable if the relevant third-party national authority has informed the firm that they, or other local laws, would not permit the inclusion of such wording. However, the supervisory statement specifically sets out that the PRA does not consider that a loss of competitiveness or profitability are grounds for concluding that the inclusion of compliant wording would be impracticable.

Liabilities used for the purposes of trade finance are singled out by the PRA as a subset of liabilities to which the "impracticable" consideration could apply, since such arrangements often fall under standardised international documentation with little scope for negotiation.

The PRA also proposes three technical amendments to the PRA Rulebook to ensure consistency with the final draft of the regulatory technical standards (**RTSs**) published by the European Banking Authority (**EBA**) under the BRRD. The technical amendments are as follows:

1. the inclusion of contractual recognition language into contracts for liabilities which are not fully secured and for secured liabilities which are not under a continuous full collateralisation requirement in accordance with EU or equivalent third-country law;
2. the inclusion of contractual recognition language into liabilities created before the date of application of the contractual recognition requirement if the agreement governing the liability is subject to material amendment after 30 June 2016; and



3. the replacement of the reference to liabilities arising after a certain date in PRA rules with a reference to liabilities created after that date – the amendment intends to ensure consistency with the draft RTSs and provide greater clarity as to which liabilities are in scope of the contractual recognition requirement.

Next steps

The consultation period is open until 16 May 2016 and the PRA intends for the amended rules to apply from 1 July 2016. The PRA acknowledges that the RTSs have not entered into law, and should any further amendments be made to the final draft versions before publication, the PRA Rulebook may require further revision.

FCA ISSUES GUIDANCE ON SMALL AND MEDIUM-SIZED BUSINESS (CREDIT INFORMATION) REGULATIONS 2015

On 8 April 2016, the FCA issued its final guidance (*FG16/4: Guidance on Small and Medium Sized Business (Credit Information) Regulations*) on the FCA's role under the Small and Medium Sized Business (Credit Information) Regulations 2015 (**Regulations**). The Regulations were made under the Small Business, Enterprise and Employment Act 2015, which aims to improve access to credit information about small and medium-sized enterprises (**SMEs**). The Regulations require, with permission of the relevant SME, designated banks to share credit information about the SME with designated credit reference agencies (**CRAs**). These CRAs must then provide this information to finance providers on request. The policy aim is to increase the amount of information available to finance providers in respect of SMEs in order to increase lender confidence and hence increase the sources of finance available to SMEs.

The Regulations create a separate monitoring and enforcement regime for designated banks and CRAs, although this monitoring and enforcement regime is entirely distinct from the regulatory regime under the Financial Services and Markets Act 2000 (**FSMA**). HM Treasury, rather than the FCA, will be responsible for the designation of banks and CRAs under the Regulations. The criteria for a bank to become designated are set out in Part 3 of the regulations and relate to the value and market share of the bank's lending to SMEs. The regulations require designated banks to share information on their SME customers with designated CRAs. Designated CRAs are required to provide equal access to that data to finance providers and to share this data with the Bank of England. In relation to complaints, the FCA states that the activities of designated CRAs under the Regulations are within the scope of the Financial Ombudsman Service (**FOS**).

The guidance is intended to explain the scope of the FCA's powers and functions under the regulations. The FCA's information gathering powers in relation to monitoring and enforcement are set out, which include the power to appoint a skilled person to prepare a report in relation to a designated entity's compliance with the regulations. The FCA expects to apply its standard risk-based approach to monitoring compliance and the general approach will reflect its approach to enforcement under FSMA, as set out in the Enforcement Guide in the FCA Handbook. Designated entities are required to maintain a record of their compliance with the regulations for at least five years from creation.

The FCA considers it disproportionate to charge a periodic fee relating to the Regulations at present. However, it may charge a designated CRA in circumstances where it has to undertake additional work because of the conduct of the CRA, as the FCA does not consider it reasonable for its costs in these circumstances to be covered by firms generally.

This guidance took effect from 1 April 2016.

UCITS REGULATIONS PASSED IN THE UK

On 18 March 2016, the Undertakings for Collective Investment in Transferable Securities Regulations 2016 (SI 2016/225) (**the 2016 Regulations**) came into force in the UK.

The 2016 Regulations implement provisions in the UCITS V Directive (2014/91/EU) relating to depositaries of Undertakings for Collective Investment in Transferable Securities (**UCITS**), sanctions for breaches of the UCITS regime, and certain requirements on the FCA relating to information and reporting.

Sanctions

The 2016 Regulations include amendments to the Financial Services and Markets Act 2000 (**FSMA**) to provide that the disciplinary powers in FSMA that are exercisable against unauthorised persons, approved persons and senior managers can be applied in the case of contraventions of requirements in the UCITS Regulations 2011 (**the 2011 Regulations**) and the 2016 Regulations. As these sanctions already meet the minimum sanctions required by the UCITS V Directive, HM Treasury deems these provisions to be adequate. The 2016 Regulations also require the FCA to publish details of all final notices on its website, including the nature of the breach and the identity of the person in breach, unless publication of personal information is disproportionate, or publication would jeopardise the stability of financial markets.

Depositories

Acting as a depository of a UCITS is a regulated activity under article 51ZB of the Financial Services and Markets Act (Regulated Activities) Order 2001. The 2016 Regulations make amendments to the 2011 Regulations to include certain provisions in relation to the liability of depositories of UCITS in the event of the loss of a financial instrument.

In particular, the amendments to the 2011 Regulations prescribe that a depositary is liable to the UCITS and the unit-holders of the UCITS where a financial instrument held in custody by the depository or a third party custodian is lost in accordance with UCITS V. A depository is also liable for losses caused by the depository's negligent or intentional non-compliance with a provision implementing UCITS V. This liability is unaffected by the delegation by a depository of its depository functions to a third party or any exclusion or limitation of liability benefitting the depository.

FCA disclosure

Where the FCA receives information relating to a UCITS from a depository and that information is necessary to another relevant EEA competent authority, the 2016 Regulations require the FCA to disclose that information to the relevant EEA competent authority. The FCA can only refuse to disclose such information in limited public interest circumstances. The FCA is also under a duty to establish procedures for the receipt and follow-up of reports on infringements of UCITS V, and disclose annual aggregate data relating to UCITS V sanctions to the European Securities and Markets Authority.

The disclosures of information pursuant to the amendments to the 2011 Regulations outlined above are brought within the scope of the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001, and employees of depositories and UCITS management companies that act as whistleblowers to ESMA in relation to the company's breaches of UCITS V are protected from victimisation in their employment by the amendments to the Public Interest Disclosure (Prescribed Persons) Order 2014.

UK ENFORCEMENT

FCA FINES FORMER HEAD OF JP MORGAN'S CIO INTERNATIONAL FOR FAILING TO BE OPEN AND CO-OPERATIVE

On 9 February 2016, the FCA issued a final notice addressed to Achilles Macris, a former head of JPMorgan Chase Bank's CIO International (**CIO International**), fining him £792,900. As an Approved Person, Mr. Macris was subject to the FCA's Statements of Principles, and was found to have failed to be open and co-operative with the Authority in relation to the difficulties faced by the Synthetic Credit Portfolio (**SCP**) (an investment portfolio for which Mr. Macris was responsible), in breach of Principle 4.

SCP portfolio losses

From 1 October 2010, CIO International was the subject of a "close and continuous" supervisory relationship with the FCA, having been identified by the FCA as posing a high probability of risk and holding the potential to cause a high impact to the FCA's statutory objectives.

Between 28 March 2012 and 29 April 2012, Mr. Macris was the head of CIO International for JP Morgan Chase Bank, an Approved Person, and the main point of contact of the FCA's predecessor, the Financial Services Authority (**FSA**). During this time, Mr. Macris was responsible for the SCP.

From January 2012 onwards, the SCP began to incur losses which increased substantially over time. The front office was instructed that no further trades should be executed and Mr. Macris was asked for daily risk reports in relation to the SCP. However, although Mr. Macris was aware of these losses, he failed to properly inform the FSA regarding their full extent. At a close and continuous supervision meeting with the FSA on 28 March 2012, Mr. Macris updated the FSA on both positive and negative developments relating to the SCP but he did not provide even a high-level and generalised indication of the full extent of the difficulties faced by the SCP. Before 10 April 2012, the SCP had breached both its CSW10 risk limit and its mark-to-market stress loss limit, but Mr. Macris had failed to notify the FSA of the occurrence of either of those events.

On 10 April 2012, Mr. Macris took part in a telephone call with the FSA after the publication of articles about the 'London whale' trades. This term was first introduced by the press to describe substantial trades of large amounts of money on complex financial instruments made by JPMorgan Chase Bank, including trades that were executed in the portfolios for which Mr. Macris was responsible. The trades involved a high level of risk and incurred losses which were covered up when trades went wrong and the problems escalated. The telephone call was initiated by Mr. Macris, however he did not provide the FSA with any suggestion that there was cause for concern with the SCP on the call, nor did he detail the extent of the losses that had occurred to date. By 29 April 2012, the SCP had recorded a year-to-date loss of over US$2 billion.

Breaches

The FCA found that Mr. Macris failed to comply with Statement of Principle 4 of the FCA's Statements of Principles for Approved Persons, which requires Approved Persons to deal with the FCA, PRA and other regulators in an open and co-operative way and to disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Both during the meeting and the telephone call, Mr. Macris created the inaccurate impression that there had been no material changes in the state of the SCP and that there were no wider causes for concern. By withholding information from the FSA regarding the status of the SCP, he delivered an inaccurate message to the FSA and hampered its investigations. At the very least, Mr. Macris should have provided a high level and generalised indication of the causes for concern in relation to the SCP. Without such an overview, the FSA was unable to follow up with questions about the nature of the concerns and form its own assessment of the position. Mr. Macris remained responsible for managing the SCP until 29 April 2012 but failed to correct the FSA's mistaken understanding of the SCP's position.

The FCA states in the final notice that the enforcement action taken against Mr. Macris is consistent with the importance it places on the accountability of those in senior positions at authorised firms. Timely and proactive communication with the FCA is of fundamental importance to the proper functioning of the regulatory system.

Sanction

Mr. Macris' failings were particularly serious in view of his seniority within JPMorgan and his involvement in and awareness of the FSA's close and continuous supervisory relationship with CIO International.

On their five-level scale where level 5 represents a more serious breach of the Statements of Principle for Approved Persons, the FCA considered that Mr. Macris' breaches amounted to a level 3 breach. The FCA took the following factors into account when reaching this decision:

- Mr. Macris' breach was committed negligently;
- the nature of the rules breached undermines the FCA's ability to effectively supervise the markets and meet its objectives;
- Mr. Macris failed to inform the FCA of the SCP's difficulties on more than one occasion; and
- Mr. Macris was an experienced industry professional and held a senior position within the firm.

In mitigation of the impacts of the breach, the FCA acknowledged the fact that JPMorgan Chase Bank clawed-back Mr. Macris' benefits upon the termination of his contract in July 2012, which he did not contest.

Level of fine

In line with the penalty provisions of Chapter 6 of the FCA's Decision Procedure and Penalties Manual, a level 3 figure fine is 20% of Mr. Macris' relevant income. Mr. Macris' relevant income was determined to be £6,293,041 and so the starting point for the fine was £1,258,608.

A 10% discount was applied in the light of the claw-back of Mr. Macris' employment benefits, and a further 30% discount was applied for early settlement at Stage 2.

The total financial penalty that was imposed on Mr. Macris for his breach of Statement of Principle 4 was £792,900.

FCA BANS FORMER DEUTSCHE BANK TRADER FOLLOWING CRIMINAL CONVICTION IN US FOR MANIPULATING LIBOR

On 29 February 2016, the FCA published a final notice addressed to Michael Ross Curtler, a former trader employed by Deutsche Bank AG (**Deutsche**), banning Mr. Curtler from performing any function in relation to any regulated activity following his conviction in the United States for conspiracy to commit wire fraud and bank fraud.

Conviction for conspiracy to commit wire fraud and bank fraud

Mr. Curtler was employed by Deutsche between 1993 and December 2012 and traded a number of financial instruments that were tied to USD LIBOR between 2000 and 2012. One of Mr. Curtler's duties whilst employed by Deutsche was, on occasion, to submit Deutsche's US$ LIBOR submissions to the British Bankers' Association. During this time, Mr. Curtler altered his US$ LIBOR submissions on request from other Deutsche traders to benefit trading positions of the individual traders and Deutsche itself. Furthermore, there were occasions when Mr. Curtler solicited such requests from traders and adjusted his submissions accordingly.

At the time, Mr. Curtler knew that his submissions were supposed to reflect the rate at which Deutsche perceived it could borrow US dollars in the London interbank market, and he knew that the alterations that he was making made those submissions false.

On 23 April 2015, the FCA had published a final notice addressed to Deutsche Bank AG for failings in relation to LIBOR, and on 8 October 2015, Mr. Curtler himself pleaded guilty before the United States District Court for the Southern District of New York to a single count of conspiracy to commit wire fraud and bank fraud.

Failings

The FCA has assessed that Mr. Curtler is not a fit and proper person to perform controlled functions. The rules contained in the FCA's Fit and Proper test for Approved Persons (**FIT**) in the FCA Handbook state that when assessing a particular person's fitness and propriety to perform a particular controlled function, the FCA will have regard to the persons honesty and integrity. In the view of the FCA, Mr. Curtler's entry of a guilty plea to a charge of fraud demonstrates the dishonesty of his character.

Sanction

The FCA viewed Mr. Curtler's misconduct as particularly serious in light of the following aggravating factors:

- Mr. Curtler was an experienced employee of Deutsche and was an Approved Person;
- Mr. Curtler engaged in improper activity over a prolonged period of time; and
- LIBOR is of central importance to the operation of UK and worldwide financial markets and doubts about the integrity of LIBOR threaten confidence in those markets.

FCA FINES AND RESTRICTS WH IRELAND FOR A FAILURE TO ADOPT ADEQUATE SYSTEMS AND CONTROLS IN RELATION TO MARKET ABUSE RISKS

On 22 February 2016, the FCA published a final notice addressed to the wealth management and corporate broking firm WH Ireland Limited (**WHI**) for a failure to adopt adequate systems and controls to properly handle market abuse risks. The FCA imposed a financial penalty of £1,200,000 and imposed a 72-day restriction preventing it's corporate broking division from taking on new clients.

A heightened risk of market abuse

WHI is comprised of a broad range of divisions and the activities it carries on includes client and corporate broking (corporate finance and arranging fund raisings), private wealth management and market making. The private wealth management function alone managed assets worth approximately £1.7bn in total.

WHI routinely receives inside information through the **private side** of its business (corporate broking and acting as nominated advisor to companies listed on AIM). There is an inherent risk at WHI of this information passing to the **public side** of WHI's business (market making, corporate stockbroking and investment research), as well as from the private side to a third party. Furthermore, WHI's employees undertake personal account dealing, which has the potential to give rise to market abuse risks without adequate recording and monitoring controls being implemented.

Breaches

The FCA found that between 1 January and 19 June 2013, WHI was in breach of Principle 3 of the FCA's Principles for Businesses by failing to take reasonable care to organise and control effective systems and controls to protect against the risk of market abuse.

WHI's failings included having inadequate market abuse policies, procedures and controls in relation to:

- the handling and disclosure of inside information;
- clear and consistent rules or recording and monitoring policies for individual employees trading on their own accounts; and
- how conflicts of interest were to be dealt with and recorded.

The FCA determined that oversight of WHI's systems and controls was not sufficient to enable WHI to fully understand and mitigate the market abuse risks in its business activities. In particular:

- there was no risk assessment or risk management framework for considering market abuse risks;
- WHI was overly reliant on an inadequately established automated trade monitoring system and the exception reports generated by it were not promptly or adequately reviewed;
- management information did not address the risks of market abuse and was not presented to the board until May 2013;
- the suspicious transaction reporting procedure was inadequately detailed and reports were not logged, escalated or reported to the board; and
- a lack of terms of reference or a specific role in respect of market abuse for the board and the compliance and risk committee meant that WHI was less able to engage with market abuse risks and issues.

In addition, training in relation to the risks of and process in relation to market abuse was inadequate for all staff, particularly for the compliance department staff. Adequate records in relation to the training undertaken were not maintained.

The FCA also found that WHI breached certain rules of the Senior Management Arrangements, Systems and Controls Sourcebook, which forms part of the FCA Handbook and relate to conflicts of interest. More specifically, WHI failed to:

- maintain a record of the kinds of activity that WHI undertakes that give rise to actual or potential conflicts of interest; and
- maintain an adequate and effective written conflicts of interest policy.

Sanction

The FCA viewed WHI's failures as particularly serious. On its five-level scale where level 5 represents a more serious breach of the market abuse regime, the FCA considered WHI's breaches amounted to a level 4 breach. Two factors contributed to this conclusion. First, the breach revealed serious and systemic weaknesses in WHI's procedures, management systems and internal controls around market abuse causing a significant risk of market abuse. Second, WHI's breaches caused a significant risk of loss to individual consumers, investors or market users.

By way of aggravating factors, the FCA also identified the following:

- the FCA had published a number of communications addressed to the industry, highlighting the importance of firms maintaining effective controls to counter market abuse risks; and

- WHI was made aware of its failings in a skilled persons report in August 2013, and had not fully implemented all of the recommended improvements.

Level of fine

Taking those factors into account, the FCA arrived at a £1,500,000 fine. After reaching an agreement for early settlement with WHI, a 20% discount was applied to this sum and the final penalty imposed was £1,200,000.

The FCA was also of the view that the imposition of a restriction on WHI's corporate broking division's ability to take on new clients would be a more persuasive deterrent than a financial penalty alone. In the light of the fact that WHI failed to implement all of the measures previously recommended to it in the 2013 skilled persons report and that the failings were widespread across the relevant business area, the FCA imposed a restriction of 90 days. The 20% discount for early settlement also applied to the restriction, which was reduced to 72 days.

UK COURT CONVICTS LIBOR MANIPULATOR TO PAY CONFISCATION ORDER

On 23 March 2016, the first person convicted for manipulating LIBOR in the UK, Tom Hayes, was ordered to pay a confiscation order totalling £878,806. Mr. Hayes had previously been convicted of eight counts of conspiracy to defraud in August 2015 and sentenced to 14 years' imprisonment, later reduced to 11 years on appeal.

Definition of confiscation order

Part 2 of the Proceeds of Crime Act 2002 (**POCA**) provides a mechanism by which the Crown Court can order a convicted individual to pay the amount of his benefit from crime. Disgorgement is designed to punish convicted offenders, deter the commission of future offences and reduce profits available to fund further criminal enterprises. The confiscation regime in POCA applies to offences committed after 24 March 2003.

In determining the amount of a confiscation order the court will consider whether the defendant has a "criminal lifestyle", whether the defendant has benefitted from their criminal conduct and the value of that benefit. The court can also make a confiscation order where the defendant does not have a criminal lifestyle, but has benefited from particular instances of criminal conduct.

Criminal lifestyle

Section 75 POCA sets out the test for whether or not a defendant has a criminal lifestyle. A defendant is deemed to have a criminal lifestyle if the offence(s) with which the defendant is charged: is specified in Schedule 2 of POCA (e.g. drug trafficking, money laundering, directing terrorism, slavery, people or arms trafficking, counterfeiting or other offences); constitutes conduct forming part of a course of criminal activity (three of more offences or two offences over a six-year period and the value of the benefit is at least £5,000 in value); or is an offence committed over a period of at least six months and the value of the benefit to the defendant is at least £5,000 in value.

Amount of the confiscation order

The prosecution (and, if requested, the defendant) will provide information to the court concerning the amount available for confiscation. This will generally be the full amount of what the court has determined to be the defendant's benefit from his criminal conduct (the "recoverable amount").

Where the court has found the defendant to have benefitted from a criminal lifestyle, the amount benefitted comprises all property transferred to or by the defendant in the six years prior to the commencement of proceedings. In addition, property obtained by the defendant after conviction is deemed to have been obtained as a result of general criminal conduct. Less punitive assumptions are applied where there is no finding of a criminal lifestyle.

However, the amount available for confiscation may be less (this is for the defendant to prove) than the recoverable amount (the available amount), which is the aggregate of: the total value of all the defendant's free property (minus court fines or orders, or prior interests that would be considered preferential in a bankruptcy); and the total value of all tainted gifts given by the defendant. A gift is a transfer of property for significantly less than the value of the property, and the gift will be deemed to have been tainted if the defendant is found to have had a criminal lifestyle and made the gift within six years of the commencement of the criminal proceedings, or if it can be shown to have been comprised, even in part, of the benefit of the defendant's criminal conduct.

The regime is intended to be tough on those convicted

of wrongdoing. Therefore, whether the defendant will have any difficulty in recovering any tainted gifts from recipients is not a factor considered by the court when setting the amount of the confiscation. There is also no test of financial hardship; confiscation orders can be made against those who have been declared bankrupt. For example, when the confiscation order of £165,731 was made against Mr Philip Boakes, a non-authorised financial adviser, the court was aware that he had no assets available to him to satisfy it.

In setting the amount of the confiscation order in the Tom Hayes case, Justice Jeremy Cooke's order considered:

- the extent to which Mr Hayes had manipulated LIBOR;
- the impact this would have had on the profits and losses made by his employers; and
- the impact this subsequently had on his remuneration throughout the five years he worked in Tokyo for UBS Group AG and Citigroup Inc.

Failure to Pay

Confiscation orders are payable at the time the order is made. If a defendant fails to pay a confiscation order within the time limit, he will serve a period of imprisonment in default – this period is set out in the confiscation order. It should be noted that serving time in prison does not extinguish the financial debt.

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

US DEPARTMENT OF LABOR ISSUES FINAL FIDUCIARY RULE AND RELATED EXEMPTIONS

The final US Department Of Labor (**DOL**) fiduciary regulation (**the Final Rule**) and other guidance published by the DOL on April 8 will have a significant effect on those who provide investment advice and sell investment products and services to employee benefit plans and Individual Retirement Accounts (**IRAs**).

The Final Rule applies to (1) employee benefit plans that are governed by the Employee Retirement Income Security Act of 1974 (**ERISA**) (referred to as **ERISA plans**) and (2) plans and arrangements, including IRAs, that are subject to Section 4975 of the Internal Revenue Code of 1986 (**the Code**). The latter category includes plans such as Keogh plans that are subject to Section 4975 of the Code but not to ERISA (**non-ERISA plans**). ERISA plans and non-ERISA plans are referred to as plans.

The effective date of the Final Rule is 7 June 2016, but the provisions of the Final Rule will not apply until 10 April 2017, referred to as the **applicability date**. Limited additional transition relief is available until 1 January 2018, under exemptions released with the Final Rule.

Summing up the final rule

The Final Rule takes an approach similar to that of the regulation proposed by the DOL in 2015 (**the Proposed Rule**). That is, the Final Rule expands the definition of *fiduciary* in the context of plan and IRA investments to cover many routine sales and marketing practices. In effect, after the Final Rule becomes applicable, there will no longer be a seller's exception for recommendations of investments to smaller plans, plan participants and IRAs. If a financial adviser recommends the purchase of an investment to these potential buyers, it will be a fiduciary, as will its employer. If the financial adviser will receive a fee based on the customer purchasing the recommended investment, the transaction constitutes self-dealing, which is prohibited in the absence of an exemption.

To address the prohibited transaction issue, the DOL has issued a best interest contract exemption (the **BIC exemption**) which is intended to allow investment recommendations to these retail buyers, but the exemption is subject to a number of strict conditions. In addition to the BIC exemption, the DOL also issued a new exemption for certain principal transactions and modified several existing exemptions.

Changes from the proposed rule

The Final Rule reflects a number of significant changes from the Proposed Rule, including the following:

- Providing that marketing one's investment advisory services to a plan (e.g., "hire me") is not fiduciary advice, unless the marketing includes specific investment recommendations.
- Deleting appraisals from the definition of fiduciary advice, to be dealt with separately in future guidance.
- Permitting the use of named investment products in asset allocation models and interactive materials for use by participants in ERISA plans (but not IRAs).
- Expanding the **seller's exception**, referred to as the exception for recommendations to independent fiduciaries with financial expertise.
- Reducing the disclosure and record-keeping requirements.

The *Best Interest Contract Exemption* was also revised in several respects, including:

- Deleting the approved asset list.
- Eliminating the requirement to provide a written contract for ERISA plans, and permitting the written contract to be provided to IRAs and non-ERISA plans at the time the investment transaction is entered into.
- Providing a mechanism to correct good faith errors without losing the exemption.

The final rule – the details

The Final Rule spells out when a person will be a fiduciary with respect to a plan or IRA as a result of providing investment advice. As a general rule, a person is an investment-advice fiduciary with respect to a plan or IRA if the person provides to a plan, plan fiduciary, plan participant, IRA or IRA owner the following types of advice for a fee or other compensation, direct or indirect:

(1) a recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred or distributed from the plan or IRA; and

(2) a recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA.

Note: The reference in this definition to the "selection of other persons to provide investment advice" makes it clear that a financial institution or adviser can solicit a plan to retain the financial institution or an affiliate to provide investment advisory services and that the solicitation is not itself fiduciary advice. This clarifying change would cover a response to an RFP from a plan requesting investment advisory services.

To be a fiduciary, a person making a recommendation must (1) represent or acknowledge that it is acting as a fiduciary; (2) render advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or (3) direct the advice to a specific recipient regarding the advisability of a particular investment or management decision with respect to securities or other property of the plan or IRA.

A "recommendation" means a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

As an example of the broad reach of this definition, the regulation notes that presenting a list of securities to a particular recipient will be a recommendation even if no recommendation is made with respect to any one security.

Also, in the preamble to the Final Rule, the DOL cautions that call centre employees who are paid only a salary will become fiduciaries if they make specific recommendations to plan participants and IRA owners.

Non-recommendations

The following activities, however, do not constitute recommendations that will trigger fiduciary status:

(1) Providing an investment platform.

Marketing or making available to a plan fiduciary a platform from which the plan fiduciary may select or monitor investment alternatives for participants in the plan. The offer of the platform must not take into account the individualised needs of the plan, its participants, or beneficiaries. This exception is intended to provide relief to service providers, such as record-keepers and third-party administrators, who provide a platform or selection of investment alternatives to participants. As one condition of this exception, the platform provider must disclose that it is not providing impartial investment advice or giving advice in a fiduciary capacity. The plan fiduciary selecting the platform must also be independent of the platform provider.

(2) Selection and monitoring assistance.

In connection with providing an investment platform, identifying investment alternatives that meet objective criteria specified by the plan fiduciary, i.e., considering parameters such as expense ratios, size of fund, type of asset. The platform provider must disclose any financial interest it has in the alternatives it recommends, including the precise nature of such interest. Also, under this exception, a platform provider may respond to an RFP by identifying a limited or sample set of investment alternatives based on only the size of the employer or plan, the current investment alternatives under the plan, or both. Finally, under this exception, the platform provider may provide objective financial data and comparisons with independent benchmarks to the plan fiduciary. However, if a platform provider offers advice that is customised to the needs of the plan, other than as specifically described above, the platform provider will be a fiduciary.

To illustrate the fine line that the DOL is drawing in this area, the preamble to the Final Rule states that a platform provider may develop and offer standardised platforms that are segmented by size of plan, e.g., platforms for small, medium and large plans. According to the preamble, the platform provider may offer these segmented platforms to

the fiduciary of a small plan, but if the platform provider states that the small plan platform is appropriate for the small plan, the line is crossed and the platform provider may become a fiduciary. The preamble also confirms that the platform provider exception is available for 403(b) plans that are subject to ERISA.

(3) General communications.

Providing general communications that a reasonable person would not view as an investment recommendation, such as general circulation newsletters, commentary in publicly broadcast talk shows, remarks in widely attended speeches and conferences, research or news reports prepared for general distribution, general marketing materials, general market data, price quotes, performance reports or prospectuses.

(4) Investment education.

Furnishing or making available to plan participants and beneficiaries information about the operation of the plan, general financial, investment and retirement information, and asset allocation models and interactive investment materials. This exception for investment education is subject to a number of restrictions, including restrictions that apply when identifying particular investment products or investment alternatives. Generally, asset allocation models and interactive investment materials provided to IRAs may not name specific investments.

Transactions not treated as fiduciary advice

The following activities would come within the general definition of fiduciary advice, but are excluded under special exceptions:

(1) Transactions with independent fiduciaries with financial expertise.

This "seller's exception" allows communications that might otherwise trigger fiduciary status if the plan fiduciary receiving the communication is in a category presumed to be sophisticated about financial matters. These "independent fiduciaries with financial expertise" are presumed to understand that they are receiving a sales pitch and that the prospective "seller" is not acting in their best interest.

The specified fiduciaries with financial expertise are (a) a bank, (b) an insurance company, (c) an entity registered as an investment adviser under the Investment Advisers Act of 1940 or registered as an investment adviser with the state in which it has its principal office, (d) a broker-dealer registered with the SEC, and (e) an independent fiduciary that holds, or has under management or control, at least $50 million

> ***Note***: The Proposed Rule had a similar seller's exception, but it was based on the number of participants in the plan, rather than the status of the plan's independent fiduciary as a financial institution or its assets under management.

The person providing the investment advice to the independent fiduciary of the plan or IRA must know or reasonably believe that the independent fiduciary is capable of evaluating investment risks independently, both in general and with respect to particular transactions and strategies. Also, the person providing the advice must inform the independent fiduciary that the person is not undertaking to provide impartial advice or to give advice as a fiduciary, and must disclose the existence and nature of the person's financial interests in the transaction. The independent fiduciary must be independent of the person providing the advice, but apparently does not have to be independent of the IRA owner or the plan sponsor. In addition, this exception will not apply if the person recommending a transaction receives a fee from the plan, plan fiduciary, IRA or IRA owner for the provision of investment advice (as opposed to the provision of other services) in connection with the transaction. Thus, if the conditions are satisfied, this exception would cover the sale of an investment product to a plan represented by an independent fiduciary with financial expertise, as defined in the Final Rule, provided that the seller is not receiving a fee for advising the plan.

(2) Swap and security-based swap transactions.

This exception allows swap dealers, security-based swap dealers, major swap participants, major security-based swap participants and swap clearing firms to provide advice to plans in connection with these types of swap transactions. The plan must be advised by an independent fiduciary, and the swap dealer, etc., may not receive a fee directly from the plan or plan fiduciary for providing advice (as opposed to other services) to the plan. (The

independent fiduciary is not required to be an "independent fiduciary with financial expertise" as defined in the seller's exception.) The person providing the advice must obtain a written representation from the plan fiduciary confirming the person's non-fiduciary status.

(3) Advice from employees.

Employees of a plan sponsor (or its affiliate), employees of a plan or a plan fiduciary, and employees of an employee organization may provide advice in connection with certain matters without becoming a fiduciary if the employee does not receive compensation for the advice beyond the normal compensation for work provided for the employer and certain other conditions are satisfied. The employer's job responsibilities cannot include the provision of investment advice, so this exception generally applies to incidental advice.

Exception for execution of securities transactions.

The execution of securities transactions by a broker, dealer or bank, without any solicitation of the trade and without the provision of any investment advice, does not result in fiduciary status under the Final Rule. However, the broker cannot have any significant discretion in connection with the transaction. For example, the instructions to the broker from the plan or IRA generally must include a price range for the transaction, a time span not longer than five business days, and the maximum or minimum amount to be purchased or sold.

Best interest contract exemption

The DOL has also revised and finalised the BIC exemption that it proposed last year. The BIC exemption is intended to allow financial institutions and the individual brokers and other advisers who work for financial institutions to market and sell investments to retail plan and IRA investors. The DOL refers to these investors as "Retirement Investors", defined to include (1) a plan participant or beneficiary who can direct investments or decide to take a distribution, (2) the beneficial owner or an IRA acting on behalf of the IRA, and (3) a retail fiduciary, defined as a plan or IRA fiduciary that is not an "independent fiduciary with financial expertise" as defined in the Final Rule.

> ***Note***: Under the definition of fiduciary in the Final Rule, marketing of investments to non-retail investors (i.e., plans advised by an "independent fiduciary with financial expertise") can be done without triggering fiduciary status.

Without an exemption such as the BIC exemption, a fiduciary to a plan or IRA cannot recommend an investment to a retail investor if it will receive a fee or other compensation as a result of the recommendation.

Deletion of the approved asset list

The final BIC exemption does not include the approved list of investment assets that was a feature of the proposed BIC exemption. Thus, any category of asset can be marketed to Retirement Investors, including IRAs, if the conditions of the exemption are otherwise satisfied. In the preamble to the final regulation, however, the DOL states:

> "The fact that the exemption was broadened [to eliminate the approved asset list] does not mean the [DOL] is no longer concerned about some of the attributes of the investments that were not initially included in the proposed definition of Asset, such as unusual complexity, illiquidity, risk, lack of transparency, high fees or commissions, or tax benefits that are generally unnecessary in these tax preferred accounts. . . . Moreover, the [DOL] intends to pay special attention to recommendations involving such products after the applicability date to ensure adherence to the Impartial Conduct Standards and verify that the exemption is sufficiently protective."

General requirements

To rely on the exemption, financial institutions and advisers must do the following:

(1) adhere to Impartial Conduct Standards, as defined in the exemption;

(2) acknowledge that they are acting as fiduciaries under ERISA or the Code, or both;

(3) adopt policies and procedures designed to ensure that advisers adhere to the Impartial Conduct Standards;

(4) disclose important information relating to fees, compensation and material conflicts of interest; and

(5) retain records demonstrating compliance with the exemption.

Impartial conduct standards – the best interest standard.

The financial institution relying on the BIC exemption must state that it and its individual advisers will adhere to the following standards (**the best interest standard**), and

must in fact comply with the standards:

(1) The investment advice provided must be, at the time of the recommendation, in the best interest of the Retirement Investor. The adviser must take into account the investment objectives, risk tolerance, financial circumstances and needs of the Retirement Investor, without regard to the financial or other interests of the adviser, the financial institution or any affiliate or related entity, or other party.

(2) The compensation of the financial institution, the adviser and their affiliates in connection with the advice must not exceed "reasonable compensation" as determined under ERISA and the Code.

(3) Statements by the financial institutions and the adviser to the Retirement Investor must not be materially misleading when they are made.

In the preamble to the BIC exemption, the DOL makes comments about the best interest standard that may be intended to make it more workable:

- "Without regard to the financial or other interests of the adviser" does not preclude the receipt of fees or other compensation by the adviser.
- The best interest standard "does not impose an unattainable obligation on advisers and financial institutions to somehow identify the single 'best' investment for the Retirement Investor out of all the investments in the national or international marketplace, assuming that such advice were even possible."
- "An adviser and financial institution do not have to recommend the transaction that is the lowest cost or generates the lowest fees without regard to other relevant factors."

Despite these statements in the preamble, however, the burden of proof will be on the financial institution or adviser, and it may be difficult for a financial institution or adviser to establish that its recommendations do not take into account the fees that it will receive, and that the recommended investment is in the best interest of the client or customer.

Written contract requirement

In the case of investment advice provided to an investor that is an IRA or Non-ERISA Plan, the financial institution must enter into a written contract with the investor, to be signed by the investor and the financial institution, stating that the financial institution and its advisers are fiduciaries and warranting that they will comply with the Impartial Conduct Standards, including the best interest standard. The contract must be entered into prior to or at the same time as the execution of the investment transaction that results from the investment advice. If the investment advice precedes the signing of the contract, the contract must by its terms apply to the period prior to the signing of the contract. The DOL has suggested that a financial institution might comply with this timing requirement by incorporating the written contract into its account opening procedures.

The written contract may include an arbitration provision, but it may not include exculpatory language limiting the financial institution's or the adviser's liability for violation of the contract. Also, the contract may not preclude the investor's participation in a class action lawsuit to enforce the terms of the contract.

This written contract requirement was included for IRAs and non-ERISA plans because the DOL has no enforcement authority over such entities. The written contract requirement does not apply to ERISA plans, but such plans can sue under ERISA to enforce the requirements of the fiduciary regulation and the obligations undertaken pursuant to the BIC exemption.

Quotas, bonuses, other differential compensation

As part of the required policies and procedures to prevent conflicts of interest, the financial institution must not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause advisers to make recommendations that are not in the best interest of a Retirement Investor. The DOL will permit the payment of differential compensation to advisers for different investment products, but solely in cases where the additional compensation reflects a neutral factor, such as the additional effort that may be needed to sell more complex investment products, such as variable annuities.

Note: The DOL has said that it is not mandating level fees and that other compensation arrangements are permissible. However, in many contexts, these required policies and procedures will require advisers to be compensated using a level fee arrangement.

Apparently a financial institution that employs brokers or other advisers may receive differential compensation in connection with investment transactions, e.g., due to the different costs associated with different products, such as equity funds vs. fixed income funds, provided that the advisers who sell the investments are paid using a level fee or other method that avoids or mitigates conflicts of interest.

Disclosure

The required disclosure includes disclosure of material conflicts of interest and the policies that have been adopted to mitigate them, typical fees and service charges, payments (if any) to be received from third parties in connection with the accounts, and whether the financial institution offers proprietary products. In addition, the financial institution must maintain a website with this information. The disclosures do not have to be repeated for sales of the same investment product within one year of the original disclosure, unless there are material changes.

Level fee fiduciary

If a financial institution or adviser that is a fiduciary charges a level fee – that is, a fee based on a fixed percentage of the value of the assets under management or a set fee that does not vary with the particular investment recommended – then a streamlined set of requirements will apply in lieu of certain of the above requirements. The fiduciary must acknowledge its fiduciary status, and it must comply with the Impartial Conduct Standards, including the best interest standard. Also, if the level fee fiduciary recommends that a Retirement Investor roll over assets from a plan to an IRA, the fiduciary must document the specific reasons for the recommendation and why it was in the best interest of the Retirement Investor. The documentation must consider the alternatives to the rollover, including leaving the assets in the Retirement Investor's current employer's plan, taking into account whether plan administrative expenses are paid by the employer or the plan. If an adviser recommends converting a commission based account to a level fee account, the adviser must document why that is in the best interest of the Retirement Investor.

Note: Although the DOL seems to favor level fee arrangements, the DOL expressed concern in the preamble that an adviser might recommend the conversion of an inactively traded commission account to a level fee advisory fee account, where the conversion would significantly increase the costs paid to the adviser or the financial institution. The DOL would not consider such advice to be in the best interest of the client or customer.

If the adviser, financial institution or any affiliate receives sales commissions in addition to the level fees, the streamlined procedures of the level fee exception will not apply, and the arrangement will have to comply with the full requirements of the BIC exception.

Proprietary products and third-party payments

The BIC exemption explicitly permits a financial institution to restrict an adviser's recommendations to proprietary products or to investments that generate third-party payments. Under this provision, the financial institution and adviser are deemed to satisfy the best interest standard, provided that they satisfy a number of conditions. The exception requires additional disclosure to the Retirement Investor of the conflicts involved. In addition, the financial institution must reasonably conclude that the limitations on the universe of recommended investments and material conflicts of interest will not result in unreasonable compensation or cause the financial institution or its advisers to recommend imprudent investments, and the financial institution must document in writing the bases for these conclusions. Also, the recommendations must be based on the investment objectives, risk tolerance, financial circumstances and needs of the Retirement Investor, and not the financial or other interests of the Adviser.

Observation: The conditions that apply to the sale of proprietary products and the receipt of third-party payments present a high threshold, one that may not be easy for a financial institution or adviser to meet. Sellers of relatively low-fee proprietary investments may be able to make the case that they qualify, but many financial institutions and advisers will find it difficult to accept the risk that they can be second-guessed by

> Retirement Investors or the DOL: "Your proprietary products are more expensive than certain generic investment alternatives. Prove that the Retirement Investor is not disadvantaged, and prove that you have not taken your fees (or third-party payments) into account in making the recommendation."

Exception for purchase of insurance and annuity contracts

The BIC exemption generally does not apply to compensation received in connection with a principal transaction. However, the BIC exemption includes an exemption for the purchase of an insurance or annuity contract from an insurance company that has a pre-existing service provider or party in interest relationship to the plan or IRA, a transaction that would otherwise be a prohibited transaction. Certain conditions must be satisfied, including that (1) the compensation for any services rendered in connection with the transaction must be reasonable and (2) the terms of the transaction must be at least as favourable as terms available in an arm's length transaction.

> ***Note***: Insurance agents and brokers who recommend and sell variable annuities, indexed annuities and similar annuities to Retirement Investors must comply with the requirements of the BIC exemption in the same manner as the sellers of other investment products. Sellers of fixed rate annuities, however, may rely on amended prohibited transaction 84-24, which imposes somewhat less stringent conditions.

Notice to DOL. A financial institution must notify the DOL before receiving any compensation if it intends to rely on the BIC exemption. The notice does not have to identify clients or transactions, and a single notification will suffice.

The BIC exemption generally has the same applicability date as the Final Rule, that is, it applies to transactions on or after 10 April 2017. However, during a transition period between 10 April 2017 and 1 January 2018, only a limited set of conditions will apply. For example, the requirement to enter into a contract with non-ERISA plans and IRAs will not apply during the transition period.

Exemption for pre-existing transactions

Transition relief is provided for securities or other investment property acquired before the applicability date under the Final Rule, subject to disclosure and reasonable compensation conditions. The pre-existing investment transition relief also applies to investments made after the applicability date pursuant to a systematic purchase program established before that date. The transition relief also covers additional investment advice with respect to the pre-existing investments after the applicability date, such as whether to sell or continue to hold the investments, subject to a limited set of conditions, including a reasonable compensation condition. Additional follow-on investments in the pre-existing investments that are made after the applicability date will not be subject to transition relief unless they are made under a systematic purchase program.

Principal transaction exemption

In 2015, the DOL proposed a new exemption that would allow an investment advice fiduciary to engage in the sale and purchase of certain debt securities to or from a plan or IRA, where the investment advice fiduciary is acting as a principal in the transaction. The DOL has now finalised that exemption with some modifications, as follows:

- The revised principal transaction exemption covers interests in unit investment trusts and certificates of deposit, as well as the debt instruments covered by the proposed exemption.
- The revised exemption does not include a requirement to obtain two independent price quotes for the debt securities involved.
- The revised exemption does not require disclosure of the mark-down or mark-up of the debt investments purchased or sold.
- The revised exemption eliminates the contract requirement for ERISA plans (similar to the contract requirement in the BIC exemption), and provides that the contract requirement for non-ERISA plans and IRAs may be satisfied at any time prior to or at the time the investment transaction is completed.
- The revised exemption contains streamlined disclosure requirements, compared to the proposed exemption.
- The revised exemption includes a mechanism for correcting good faith violations of the disclosure conditions.
- The revised exemption covers "riskless principal transactions", as defined below.

The final version of the exemption covers purchases and sales of "principal traded assets". In the case of purchases by a Retirement Investor, a principal traded asset is defined as a debt security, a certificate of deposit or an interest in a unit investment trust. For this purpose, a debt security includes a registered debt security issued by a US corporation, an agency debt security, an asset backed security guaranteed by an agency or by a government sponsored enterprise, and a US Treasury security. In the case of sales by a Retirement Investor, a principal traded asset includes any securities or other investment property. The broader definition for sales by a plan or IRA is intended to enhance the liquidity of investments for such investors.

In the case of the purchase of a debt security, the adviser must determine that the debt security possesses no more than a moderate credit risk, and that it is sufficiently liquid that it could be sold at or near its carrying value within a reasonably short period of time. The preamble to the exemption states that the "moderate credit risk condition" is intended to identify investment grade securities, although the DOL acknowledges that the Dodd-Frank Act does not permit explicit reliance on credit ratings.

In addition, the final principal transaction exemption covers "riskless principal transactions" involving principal traded assets. A riskless principal transaction is a transaction in which a financial institution, after having received an order from a Retirement Investor to buy or sell a principal traded asset, purchases or sells the asset for the financial institution's own account to offset the contemporaneous transaction with the Retirement Investor. Commenters on the proposed principal transaction exemption had told the DOL that many transactions with plans are carried out as riskless principal transactions, and that such transactions are similar to agency transactions in which a financial institution acquires an investment for an investor without taking title to the investment. This type of transaction does not involve the risk that a financial institution will "dump" an unfavorable investment it has made on the Retirement Investor.

The conditions for application of the principal transaction exemption are similar to the conditions of the BIC exemption. The financial institution that engages in the transaction with a Retirement Investor must adhere to the best interest standard, acknowledge fiduciary status, avoid misleading statements, disclose fees and material conflicts of interest and adopt policies and procedures designed to mitigate conflicts of interest. These requirements must be included in a written contract if the transaction is with an IRA or non-ERISA plan. The financial institution must also seek to obtain best execution of the transaction.

Amended exemptions

The DOL finalised a number of changes to existing prohibited transaction exemptions (**PTEs**), generally in line with the proposed changes to exemptions in 2015. Two key changes were the incorporation of the Impartial Conduct Standards into existing exemptions, and the revision of certain exemptions to exclude IRAs, forcing them to rely on the BIC exemption. The changes to the exemptions, which will be effective on 10 April 2017, include the following:

- PTE 84-24 was amended to limit that exemption to fixed rate annuity contracts, and to exclude plan and IRA purchases of annuities that do not fit the definition of fixed rate annuity contracts. Those other annuity contracts, *i.e.*, variable annuities, indexed annuities and similar annuities, now must qualify for exemption under the BIC exemption. In addition, PTE 84-24 was amended to incorporate the Impartial Conduct Standards (although not the contract requirement) for transactions covered by the exemption and to eliminate the exemption for IRA purchases of investment company securities.
- PTE 86-128 and parts of PTE 75-1, which permitted the receipt of fees in connection with certain mutual fund and other securities transactions entered into by plans and IRAs, were amended to include the Impartial Conduct Standards and to exclude IRAs from the exemption, forcing them to rely on the BIC exemption.
- PTE 75-1, which allowed broker dealers to extend credit to a plan in connection with the purchase or sale of securities, was amended to extend the exemption to the receipt of fees for the extension of credit to a plan or IRA by a broker dealer to avoid a failed securities transaction.

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IMPORTANT CHANGES TO AML RULES FOR INVESTMENT ADVISERS COMING THIS YEAR

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

In the proposed rule**,** FinCEN would require investment advisers that are registered or are required to be registered with the SEC (generally those with US$100 million or more in regulatory assets under management, or those not regulated by a state authority) to maintain AML programs and to file reports of suspicious activity. FinCEN noted, however, that it may consider expanding the scope in the future to include small and mid-sized advisers because they are also at risk for "abuse by money launderers, terrorist financers, and other illicit actors."

By scoping SEC-regulated investment advisers into the definition of "financial institution" under the BSA at this time, FinCEN would also require these investment advisers to abide by the requirements of the BSA that are generally applicable to financial institutions and allow for coordination between FinCEN and the SEC for application and examination of the requirements. By amending the definition of "financial institution", FinCEN believes that it is closing the door to potential financers of terrorism or money launderers who could otherwise take advantage of investment advisers' lack of AML programs and/or BSA compliance to gain access to the US financial system.

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

In connection with the proposed rule, FinCEN posed several questions to potential commenters regarding the risk for abuse by money launderers and terrorist financers: whether the rule adequately captures the institutions that are most vulnerable to this risk; whether foreign advisers should also be captured in the definition of "financial institution"; and what the potential burden may be on the regulated institutions.

These and other issues will likely be addressed in the final rule, which will likely be published by FinCEN in 2016. As proposed, investment advisers would have six months from the date on which the rule becomes final to implement and comply with its requirements. We also anticipate further joint rulemakings between SEC and FinCEN in the coming months.

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EXPANDING PERSONAL LIABILITY FOR CHIEF COMPLIANCE OFFICERS: MINNESOTA FEDERAL COURT DECISION, PROPOSED NEW YORK REGULATION CONTINUE THE TREND

A recent decision from a federal district court and a proposed regulation from the New York State Department of Financial Services provide even more reason for compliance officers at financial institutions to install robust anti-money laundering compliance programs.

Under the district court decision and proposed regulation, chief compliance officers would be personally subject to both civil and criminal liability if their institution's anti-money laundering compliance programs are incapable of detecting and stopping illicit transactions.

In January, a federal district court held that the compliance officers of financial institutions can be held civilly liable for failing to ensure their institution's compliance with the

Bank Secrecy Act of 1970's anti-money laundering provisions. In *U.S. Dep't of Treasury v. Haider*, No. 0:15-cv-01518 (D. Minn.), the Treasury Department's Financial Crimes Enforcement Network (FinCEN) alleged that MoneyGram's former chief compliance officer – Thomas Haider – failed to take sufficient action to terminate, and failed to file Suspicious Activity Reports (SARs) in relation to transactions he had reason to believe were related to money laundering, fraud, or other illegal activity. FinCEN fined him US$1 million and brought action in federal court to collect the fine.

Haider sought dismissal of the fine, arguing that the Bank Secrecy Act applies to institutions, not individuals. The court disagreed and denied his motion, reasoning that the Bank Secrecy Act's civil penalties provision applies to partners, directors, officers, and employees of financial institutions. No final disposition has been reached in the case, but the district court's decision makes clear that FinCEN is empowered to impose personal liability on compliance officers. In addition to a US$1 million fine, Haider faces a permanent ban from employment in the financial industry.

The District Court's decision followed closely on the heels of New York Governor Andrew Cuomo's issuance of a proposed regulation that would require the chief compliance officers (or their functional equivalent) of financial institutions to annually certify that their anti-money laundering compliance programs are effective at identifying and preventing illicit transactions. If a compliance officer's certification is later found to be false, the officer would be subject to criminal liability. Governor Cuomo's proposal was motivated by concerns that terrorist organizations are using American banks as pass-throughs for illicit funds.

A final rule has not yet been issued (though one is expected in the coming weeks), but, under the proposed regulation, compliance officers would be required to certify that their anti-money laundering compliance programs include, among other things, the following:

- a satisfactory monitoring program that identifies transactions that potentially violate the Bank Secrecy Act or other anti-money laundering laws and regulations, or which give rise to Suspicious Activity Reporting obligations. What constitutes a satisfactory monitory program will be dependent upon the risk profile of the institution, as well as its businesses, products, services, and customers;
- a Watch List filtering program that prevents the execution of any transactions prohibited by sanctions, including OFAC and other sanctions lists, politically exposed persons lists, and internal watch lists;
- sufficient oversight to ensure that both the Watch List filtering program and transaction monitoring program are operated by qualified and well-trained personnel or vendors; and
- periodic auditing and testing of the anti-money laundering programs efficacy.

The imposition of personal liability on chief compliance officers is part of the regulators' broader interest in compliance failures at the highest levels of financial institutions. On 21 February 2016, the Financial Industry Regulatory Authority (FINRA) sent letters to a dozen financial firms, inquiring about the methods by which the firms establish and maintain a culture of compliance. In addition to requesting general information on the firms' practices, FINRA specifically requested information on how the firms established a 'tone from the top'. FINRA characterised the request letters as an attempt to better understand how culture affects compliance, but the focus on the 'tone from the top' suggests FINRA perceives or is at least particularly concerned about deficiencies among the highest ranking executives of financial firms.

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THE BLOCKCHAIN REVOLUTION, SMART CONTRACTS 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 (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

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.

The smart contract

Although the blockchain was developed to facilitate cryptocurrency transactions, entrepreneurs are now developing the technology for use in 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.

Using smart contracts in financial deals

Financial transactions are one potential way to use smart contracts. Smart derivatives contracts could be coded so that payment, clearing, and settlement occur automatically in a decentralised manner, without the need for a third-party intermediary, such as an exchange or clearinghouse. For example, a smart derivatives contract could be pre-programmed 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 record-keeping, 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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THE U.S. AND THE EU REACH AN HISTORIC AGREEMENT ON CCPS GLOBAL EQUIVALENCE: HOW WILL IT AFFECT YOU?

On 10 February 2016, the U.S. Commodity Futures Trading Commission ("CFTC") and the European Commission agreed on a common approach to harmonising transatlantic regulations regarding the central clearing of derivatives by clearing houses, or central clearing counterparties ("CCPs").[2] The agreement represents an historic step in allowing market participants to utilise clearing infrastructures in both the U.S. and Europe, and assuring a level playing field for U.S. and EU CCPs.[3]

[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.

Prior to this agreement, U.S. and EU regulators had been unable to unite their efforts to regulate CCPs under a unified regulatory regime. CCPs interpose themselves between counterparties in derivatives transactions to ensure future performance of open contracts and mitigate the transaction risk posed by potential defaults. Given the extent to which the derivatives market is driven by cross-border transactions between the U.S. and Europe, the lack of unity in their approaches to derivatives clearing created a costly and complex regulatory framework.

Under the agreement, the U.S. and the EU will harmonize their clearing requirements and work together to oversee CCP compliance with a more uniform set of rules.

1. Impact for the EU

For its part, the EU will require customers of clearing houses to post more margin, allowing it to align with U.S. standards. To implement the agreement, the European Commission intends to adopt an equivalence decision regarding CFTC requirements. Once recognised by the European Securities and Markets Authority (**EMSA**), the equivalence decision will permit U.S. CCPs to continue providing services in the EU by complying with CFTC requirements. They will also be considered a "qualifying CCP" under the European Capital Requirements Regulation, therefore lowering costs for European banks.[4]

The EU's equivalence decision is conditioned on a determination that CFTC-registered U.S. CCPs have internal policies and procedures to ensure that: (1) sufficient initial margin is collected to satisfy a two-day liquidation period for clearing members' proprietary positions in exchange traded derivatives; (2) initial margin models incorporate measures to mitigate the risk of procyclicality; and (3) default resources are maintained to withstand default by two members with the largest credit exposure.[5] The aforementioned conditions will not apply to U.S. agricultural commodity derivatives traded and cleared domestically, since such markets are relatively isolated from the larger financial system.

2. Impact for the U.S.

Correspondingly, the U.S. will require more margin to be posted by members of clearing houses (such as banks) to align requirements with EU standards. In discussing the agreement, Chairman Massad suggested that "CCPs on both sides of the Atlantic will be held to high standards and that the CFTC and European authorities will work together on oversight of these CCPs."[6]

The CFTC plans to adopt a substituted compliance determination allowing EU CCPs to adhere to CFTC's rules by complying with corresponding European requirements. This determination will apply to EU CCPs already registered as derivatives clearing organizations (**DCOs**) with the CFTC, as well as those planning to register with the CFTC under the substituted compliance regime.

The agreement comes in advance of the 21 July 2016 deadline for phasing in mandatory derivatives clearing in the EU. Without the accord between the U.S. and EU, European banks using U.S. clearing houses would have faced a significant increase in capital requirements for transactions occurring from 21 July onwards. While ESMA has up to 180 working days to consider a recognition of equivalence, the European regulator has indicated that it plans to recognise the decision as soon as practicable once U.S. CCPs meet their conditions under the decision.[7] The CFTC has also indicated that it plans to streamline the registration process for EU CCPs seeking to register with it through the substituted compliance programme.

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[2]. Joint Statement between the U.S. Commodity Futures Trading Commission and the European Commission on Common Approach for Transatlantic CCPs, (Feb. 10, 2016), *available at* http://ec.europa.eu/finance/financial-markets/docs/derivatives/20160210-eu-cftc-joint-statement_en.pdf [hereinafter *Joint Statement*].

[3]. The common approach references only the CFTC's requirements for derivatives clearing organizations and not the requirements for clearing agencies established by U.S. Securities and Exchange Commission ("SEC"), though the European Commission is working with SEC staff to incorporate clearing agency requirements into its equivalence analysis.

[4] Commission Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation 648/2012, 2013 O.J. (L 176), 1.

[5] Joint Statement, *supra* note 1.

[6] Timothy Massad, Chairman, Commodity Futures Trading Comm'n, Statement of Chairman Regarding Common Approach for Transatlantic CCPs (Feb. 10, 2016).

CFPB ENFORCEMENT ACTION AGAINST A FINTECH FIRM

On 2 March 2016, the Consumer Financial Protection Bureau (**CFPB**) issued an enforcement action in a consent order to resolve claims against a financial technology (**FinTech**) firm that provides an online platform for payment transactions. The consent order, which will be in effect for five years, requires that the FinTech firm: (1) pay a civil monetary penalty of US$100,000; (2) enact various measures designed to better protect the personal information of its customers; and (3) undergo semi-annual data security assessments and annual data security audits.

Consent order findings

The consent order relates to the firm's consumer disclosures regarding data security practices, which the CFPB alleges violated the unfair, deceptive, and abusive practices (**UDAAP**) provisions of the Consumer Financial Protection Act (**CFPA**). According to the CFPB, the firm misrepresented that its data security controls, network, and transactions were "safe and secure" and compliant with Payment Card Industry (**PCI**) standards. The firm also misrepresented on its website or in direct communications with consumers that its data security practices "exceed... or surpass industry security standards" and set "a new precedent for the industry for safety and security."

In fact, the CFPB determined that the firm was not PCI compliant, did not use encryption technologies to safeguard personal information, and solicited such information directly from customers via email. According to the CFPB, the firm failed to: (1) adopt and implement reasonable data security measures appropriate for the firm; (2) conduct risk assessments to identify foreseeable security risks; (3) provide adequate data security training to its employees; and (4) practice secure software development with respect to consumer-facing applications. The CFPB concluded that the firm's data security statements constituted deceptive acts likely to mislead a reasonable consumer into believing that the firm had reasonable and appropriate data security practices in place.

Noteworthy factors

Despite the relatively modest civil monetary penalty imposed by the CFPB, the enforcement action is noteworthy for a few key reasons:

- It is the first data security-related enforcement action for the CFPB, an agency created by the Dodd-Frank Act to enforce consumer financial protection laws. The agency joins a host of other federal regulators policing this space, including the Federal Trade Commission, Securities and Exchange Commission, Commodity Futures Trading Commission, Financial Industry Regulatory Authority, National Futures Association, and Department of Justice.
- As a preliminary matter, the CFPB confirmed its belief that the firm was a "covered person" under the CFPA. This shows a fairly extensive reach by the CFPB to FinTech firms that play a role, but are not the primarily participants, in consumer financial transactions.Until this point, the CFPB has primarily focused its attention on direct lenders, servicers and other participants in the consumer credit space. The CFPB's decision to bring an enforcement action against a payment processing start-up is an indication that the agency is expanding its focus to include additional market participants who pose data security risks to consumers.
- In the consent order, the CFPB never alleges that the firm was ever the victim of any data breach. This indicates that the agency is adopting an aggressive stance in prosecuting firms for failing to adequately protect personal information, even in the absence of any unauthorised disclosure of such information to third parties.

Key takeaways for FinTech companies

FinTech firms that play a role in consumer financial transactions should be aware of the CFPB and its enforcement authority, particularly under the UDAAP provisions of the CFPA. Moreover, FinTech firms subject to CFPB oversight should examine public statements regarding their data security practices to ensure that they accurately reflect the state of their programmes. The consent order also provides useful guidance for FinTech firms wishing to assess how their data security practices measure up against CFPB expectations and seeking insights into expectations related to substantial board of directors' oversight and involvement.

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[7] Press Release, European Securities and Markets Authority, ESMA resumes US CCP recognition process following EU-US agreement (Feb. 10, 2016), *available at* https://www.esma.europa.eu/sites/default/files/library/2016-278_eu-us_approach_ccp_equivalence.pdf.

AUSTRALIA

ASIC AND THE FCA ENTER INTO A CO-OPERATION AGREEMENT TO SUPPORT INNOVATIVE BUSINESSES

On 23 March 2016, the Financial Conduct Authority (**FCA**) and the Australian Securities and Investments Commission (**ASIC**) (the **Authorities**) entered into a co-operation agreement.

Both the FCA (Project Innovate, October 2014) and ASIC (online Innovation Hub, April 2015) have recently established innovation hubs designed to promote financial innovation in their respective markets. The co-operation agreement sits within the context of these two initiatives and is designed to provide a framework for co-operation and referrals between the innovation hubs of each authority.

Referral mechanism

The two Authorities agree to refer to each other, through their respective innovator hubs, innovator businesses who would like to enter the other's market. Each Authority will set out a Criteria for Support which will outline the criteria that must be met, from time to time, by an innovator business before a receiving Authority will offer its support to the business. Referrals shall be made in writing and outline how the innovator business meets the receiving Authority's Criteria for Support. Once the referral has been made, the receiving Authority will support the innovator business in accordance with the agreed terms outlined below.

Support provided

Support offered by the Authorities to incoming innovator businesses includes:

- a dedicated team and contact for each business;
- help for the business to understand the regulatory framework in the relevant Authority's jurisdiction;
- assistance during the pre-authorisation application phase to discuss the authorisation application process and any relevant regulatory issues identified;
- an authorisation process for innovator businesses that efficiently deals with applications for authorisation including:
  - (i) consideration by relevant authorisation staff of any assistance provided to the business during the pre-application phase; and
  - (ii) the allocation of authorisation staff that are knowledgeable about financial innovation in their respective markets to consider the application; and
- a dedicated contact and the provision of additional assistance for the first year after the business is authorised.

Information sharing

The co-operation agreement also sets out that the Authorities agree to share information about relevant innovations where appropriate, including, but not limited to, emerging market trends, and developments and regulatory issues pertaining to innovation in financial services.

Christopher Woolard, FCA director of strategy and competition, comments that, along with ASIC, the FCA aims to reduce the barriers for authorised firms looking to grow to scale overseas, and to assist non-UK innovators interested in entering the market overseen by the FCA. He adds that the FCA hopes the agreement with ASIC will be the first of many such agreements.

NETHERLANDS

SURCHARGING – PROPOSED PROHIBITION IN DUTCH LAW

On 7 January 2016 the proposed amended legislative bill on the prohibition of a surcharge for the use of payment instruments by consumers (*Wet verbod toeslag gebruik betaalmiddelen bij consumenten*) was published. The initiator of this legislative bill (which is an initiative of a parliamentarian, rather than a government proposal) strives for its entry into force by 1 July 2016. Since the proposal is not controversial, it is expected to obtain parliamentary approval without much discussion.

Present legislative framework

Current European and Dutch law allows a beneficiary/payee to levy a surcharge on a payer for the use of certain payment instruments (e.g. a credit card). According to the Payment Services Directive (EC) No. 2007/64 (**PSD-I**), Member States are allowed to forbid or limit the right to request charges, taking into account the need to encourage competition and promote the use of efficient payment instruments. The Dutch legislator has not yet made use of this discretion.

Following the Directive on Consumer Rights (EU) No. 2011/83, fees charged to consumers must not exceed the actual cost of the use for the merchant. This restriction is implemented in Article 6:230k(1) of the Dutch Civil Code (**DCC**).

The Regulation on interchange fees for card-based payment transactions (EU) No. 2015/751 (**IFR**) contains – among other things – provisions limiting interchange fees for consumer debit card transactions to 0.2% of the transaction value and with regard to consumer credit card transactions to 0.3% of the value of a transaction. These particular articles entered into force on 9 December 2015. Pursuant to those provisions, Member States are allowed to define an even lower interchange fee cap than the fees provided for in those articles.

An interchange fee is a fee paid for each transaction directly or indirectly (i.e. through a third party) between the issuer and the acquirer involved in a card-based payment transaction. The net compensation or other agreed remuneration is considered to be part of the interchange fee.

Anticipated legislation

The revised Payment Services Directive (EU) No. 2015/2366 (**PSD-II**) entered into force on 12 January 2016 and will repeal PSD-I with effect from 13 January 2018. Member States must adopt and publish the measures necessary to comply with PSD-II by 13 January 2018.

PSD-II states that "*[…]* Any charges applied shall not exceed the direct costs borne by the payee for the use of the specific payment instrument."

Pursuant to PSD-II, Member States are under an obligation to ensure that the payee does not request charges for the use of payment instruments for which interchange fees are regulated under Chapter II of IFR and for those payment services to which Regulation (EU) No. 260/2012 applies.

In the preamble to PSD-II, Member States are explicitly called on to prohibit surcharges for payment transactions of which the interchange fees are regulated in IFR, prior to the implementation of PSD-II. Furthermore, as in PSD-I, PSD-II allows Member States to prohibit or limit the right of the payee to request charges, taking into account the need to encourage competition and promote the use of efficient payment instruments.

The proposed legislative bill

The amended Explanatory Memorandum to the proposed bill on the prohibition of surcharges for the use of payment instruments by consumers, states that it is exceptionally difficult (if not impossible, due to the confidential nature of the underlying agreements) to monitor compliance with Article 6:230k (1) DCC which makes it possible for merchants to overcharge consumers. Merchants indeed frequently overcharge consumers. The Netherlands Authority for Consumers and Markets (*Autoriteit Consument en Markt*), which enforces Article 6:230k (1) DCC, rarely takes action against overcharging.

The amended proposed bill envisages not only prohibiting charging sums exceeding the actual cost, but prohibiting merchants from charging consumers for the use of a specific payment instrument entirely. Among other arguments, the prohibition of surcharging would promote the use of efficient payment instruments, as merchants are unable to steer towards a certain payment instrument and the consumer would be able to choose between payment instruments on a cost-neutral-basis.

The envisaged consequences

In the event that the proposed amended legislative bill passes through the Dutch House of Representatives (*Tweede Kamer der Staten Generaal*) in its current form and subsequently in the Senate (*Eerste Kamer der Staten Generaal),* subsection 1 of Article 6:230k DCC will be amended, along with other articles. As a result of the proposed amendment, merchants will generally be prohibited from requesting a fee from a consumer for the use of certain payments instruments. The prohibition of surcharging will be enforced by the Netherlands Authority for Consumers and Markets. A complete prohibition will be easier to enforce than the existing legislation. In the event that a merchant breaches the prohibition, the Netherlands Authority for Consumers and Markets may impose a penalty of up to €450,000 per violation.

As examples of goods and services whereby surcharges for the use of specific payment instruments are frequently imposed, the amended Explanatory Memorandum to the proposed legislative bill refers explicitly (but not exclusively) to airline tickets, electronics, tickets for events and (packaged) travel. Transactions with payment cards issued by three – and four-party payment card schemes (e.g. Diner Club-cards and American Express cards) are also envisaged to be within the scope of the amended proposed bill. However, the laws regarding surcharges concerning the use of commercial cards remain unaffected by this bill.

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INTERNATIONAL

IOSCO PUBLISHES REPORT ON CYBER SECURITY IN SECURITIES MARKETS

On 6 April 2016, the International Organisation of Securities Commissions (**IOSCO**) published a report (FR02/2016 – *Cyber Security in Securities Markets – An International Perspective – report on IOSCO's cyber risk coordination efforts*) reviewing the high level regulatory approaches and tools available to regulators to improve securities market participants' cyber security frameworks.

The report also describes certain practices adopted by particular market participants and illustrates that in general, policy response to cyber security issues by regulators is still in its infancy.

This report has been published in response to an increased cyber risk and the growing threat of cyber-attack to market participants, together with the increased challenges presented by this rapidly evolving and complex phenomenon. IOSCO is of the view that cyber risk is a substantial one. The human element of the manner in which cyber threats evolve over time requires regulators to adopt a specific cyber risk regime.

Reporting issuers – disclosure

In line with the existing disclosure framework, IOSCO reminds issuers of the importance of disclosing material information, including in relation to cyber risk.

Where issuers identify cyber risk to be a material risk that IOSCO members may take into account when regulating issuer disclosure in their jurisdiction, IOSCO recommends that issuers consider making the following disclosures:

- the reasons why the issuer is subject to cyber risk;
- the source and nature of the cyber risk, and how the risk may materialise;
- the possible outcome of a cyber-incident (e.g. effects on third parties, costs of remediation);
- the adequacy of preventative measures and management's strategy for mitigating cyber risk; and
- whether a material breach has occurred before, and how this might affect the issuer's overall cyber risk.

IOSCO reminds reporting issuers that any disclosure should be tailored to the particular issuer and should not include information that could compromise their cyber security.

Trading venues

The report identifies specific cyber threats that are considered to be the most relevant to trading venues and outlines in detail the steps in the transaction chain, from the pre-trade stage to the on-going monitoring of the venues, that are considered to be particularly vulnerable to cyber security threats.

IOSCO identifies the main threats to the cyber security of trading venues as including:

- **hacktivists** seeking to draw attention to a particular cause and targeting specific trading venues, as highlighted by the Hong Kong Exchange in 2011, where trading was halted following a targeted attack on several blue-chip companies' securities;
- **cyber criminals** breaching trading venues' security systems with a view to illegally acquiring funds; and
- **breaches of confidential information**, including documents stored at trading venues as well as the threat of the inappropriate use of inside information by employees or former employees of such venues.

By way of guidance for firms that are considering their cyber security policies and procedures, IOSCO sets out in some detail a range of practices that market participants have adopted to date, along with an analysis of various authorities' regulatory approaches to current cyber security threats. IOSCO recognises that the different regulatory approaches are broadly internationally compatible, as regulators in general place comparable expectations on trading venues' security processes. The report also highlights the need for trading venues to ensure that sound testing regimes are in place to ensure the on-going adequacy of the policies and procedures that have been implemented.

Market intermediaries

IOSCO has established a working group to provide feedback and assistance in relation to the issue of intermediaries and cyber security. Chapter 4 briefly sets out examples of regulatory actions taken in Mexico and the United States in relation to this issue.

Asset managers

Chapter 5 identifies the following as the main potential cyber security risks for asset managers:

- data theft;
- data and algorithm manipulation;
- availability of systems, and the ability to execute trades and maintain public websites; and
- the risks posed by trusted insiders.

The US Securities and Exchange Commission's data from 2014 shows that an average of 74% of advisers stated that they had experienced cyber-attacks directly or through one of their vendors.

The chapter then considers the results of the AMCC Asset Management Cybersecurity Benchmarking Survey, which was completed by members of IOSCO's AMCC working group. The survey gathers data relating to market practices and security systems in relation to respondents' cyber security.

IOSCO concludes that regulators around the world have taken different approaches towards tackling the cyber security risks that asset managers face. IOSCO advises that an increasing number of investment managers may start to be sanctioned for failings in their cyber security practices, whilst, generally speaking, the majority of regulators promote a robust cyber security posture across the industry through guidance. It is broadly acknowledged that a detailed and prescriptive approach to regulating cyber security risk is unlikely to work given the pace of technological innovation and changing sophistication of adversaries.

Financial market infrastructures

The Committee on Payment and Market Infrastructures-IOSCO Working Group on Cyber Resilience (**WGCR**) was formed in September 2014 to address the issues that cyber risk may pose to the well-functioning of financial market infrastructures and to financial stability. The WGCR published a draft document to provide guidance to financial market infrastructures to enhance their approach to cyber risk. The draft document identifies five key risk management categories that should be addressed:

- **sound governance**, involving a clear and comprehensive cyber resilience framework;
- **identification** of critical business functions and supporting information assets that should be protected;
- **protection** of confidentiality, integrity and availability of financial market infrastructures through effective security controls;
- **detection** of anomalies and cyber security events; and
- **response and recovery**, financial markets infrastructures should design and test its systems and processes to enable the safe resumption of critical operations within two hours of a cyber-disruption.

Concluding remarks

The Report concludes by recognising the important cyber security challenges faced at an international level by both regulators and market participants and the importance of ensuring that cross-jurisdictional mechanisms are in place to promote greater awareness and information sharing at an international level to mitigate the risk of potential cyber attacks.

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IN FOCUS

FCA ISSUES FINAL RULES ON SEGREGATION OF CLIENT MONEY BY CROWDFUNDING PLATFORM OPERATORS, THE IFISA AND NEW P2P ADVICE REGULATED ACTIVITY

On 21 March 2016, the FCA published a policy statement (*PS16/08: FCA Handbook changes regarding the segregation of client money on loan-based crowdfunding platforms, the Innovative Finance ISA, and the regulated activity of advising on peer-to-peer agreements*) outlining the final rules relating to the segregation of client money on loan-based crowdfunding platforms, the introduction of the Innovative Finance ISA (**IFISA**) and the new regulated activity of advising on peer-to-peer (**P2P**) agreements.

The approach outlined in the paper follows on from two consultation papers: *CP16/4: loan based crowdfunding platforms and segregation of client money* which was published on 21 January 2016, and *CP16/5: Handbook changes to reflect the introduction of the Innovative Finance ISA and the regulated activity of advising on peer-to-peer agreements,* which was published on 2 February 2016. The FCA received positive feedback during the consultation period and the final rules take forward the FCA proposals outlined in the two consultations.

Segregation of client money on loan-based crowdfunding platforms

Chapter 2 of the policy statement explains the final rules in relation to the segregation of client money on loan-based crowdfunding platforms. These rules take forward the FCA's initiatives to protect consumers by ensuring that firms provide it with sufficient information in order to be able to assess the risks of loan-based crowdfunding. The changes to the rules set out in this chapter came into force on 21 March 2016.

The FCA aims to simplify client money arrangements for firms that hold money in relation to both P2P and business-to-business (**B2B**) agreements. The new rules allow firms to elect to hold all of their clients' money relating to this business under chapter 7 of the Client Assets Sourcebook (**CASS**).

If making the election above causes a firm's CASS firm size to change from CASS small to CASS medium or CASS large, the firm will need to submit a client money and assets return (**CMAR**). The FCA has introduced a year's transitional period for firms in this position, and firms will have until the following annual stratification exercise (in January 2017) before they will need to submit their CMARs. However, such firms need to be able to provide CMAR data upon request during FCA supervisory visits in this period.

The Innovative Finance ISA

Chapter 3 of the policy statement confirms the approach proposed by the FCA in CP16/5 in relation to IFISAs. This guidance took effect on 6 April 2016. The FCA sets out guidance on existing financial promotion and disclosure rules to clarify the types of information firms should provide in relation to IFISAs. In particular, the FCA clarifies that firms should disclose the following:

- the potential tax disadvantages arising if a consumer invests in a P2P agreement, held in an IFISA wrapper, which is not repaid;
- the potential tax disadvantages if the firm operating the platform fails;
- the procedure applying, tax consequences arising and timeframes involved if an investor wants to cash in a P2P agreement held in an IFISA wrapper; and
- the procedure for transferring some or all of the P2P agreements held in an IFISA wrapper from one ISA manager to another and how long this would be expected to take.

The guidance is at a very high level and aims to ensure that investors will be aware of the specific IFISA-related risks. The FCA expects firms to provide sufficient information in relation to the tax position of IFISAs before the business is transacted so that customers are aware of potential disadvantages in case a P2P agreement held in an IFISA wrapper is not repaid, or the customer looks to transfer the IFISA from one ISA manager to another.

Advising on peer-to-peer agreements

As of 6 April 2016, the provision of advice in relation to P2P agreements is a regulated activity under the amended Article 53(2) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. Having reviewed the responses to CP16/5, the FCA sets out its new rules, which came into force on 6 April 2016, to account for this new regulated activity in line with the proposals outlined in its earlier consultation paper.

The rules are intended to bring the regulation of advising on P2P agreements more in line with the regulation of advising on specified investments. In particular, the FCA will apply the suitability requirements contained in chapter 9 of the Conduct of Business Sourcebook (**COBS**) and the rule on inducements found in COBS 2.3.1R to firms that make personal recommendations in relation to P2P agreements. The rules outline that those advising retail clients on P2P agreements should be qualified under existing retail investment advice qualifications. Since the FCA considers that the rules in the Training and Competence Sourcebook are appropriate to ensure that employees adequately understand the differences between standard ISAs and the IFISA, the rule changes do not include extending the appropriateness test to P2P agreements when sold on a non-advised basis.

Furthermore, firms that hold themselves out as independent financial advisers (**IFAs**) are not obliged by the rules to consider P2P agreements when making personal recommendations to their clients. Following the Retail Distribution Review, IFAs must consider *all retail investment products* which are capable of meeting the investment needs and objectives of a retail client when making personal recommendations to them. The rules specifically stipulate that IFAs do not need to consider P2P agreements in the basket of all retail investment products when providing a personal recommendation to a retail client. The FCA recognises that not all advisers will be in a position to advise on P2P agreements as a matter of course, and so it does not deem it appropriate to require IFAs to consider such agreements when advising their clients. Where an IFA does provide advice in relation to P2P agreements, this advice will amount to a regulated activity and the IFA will need authorisation from the FCA.

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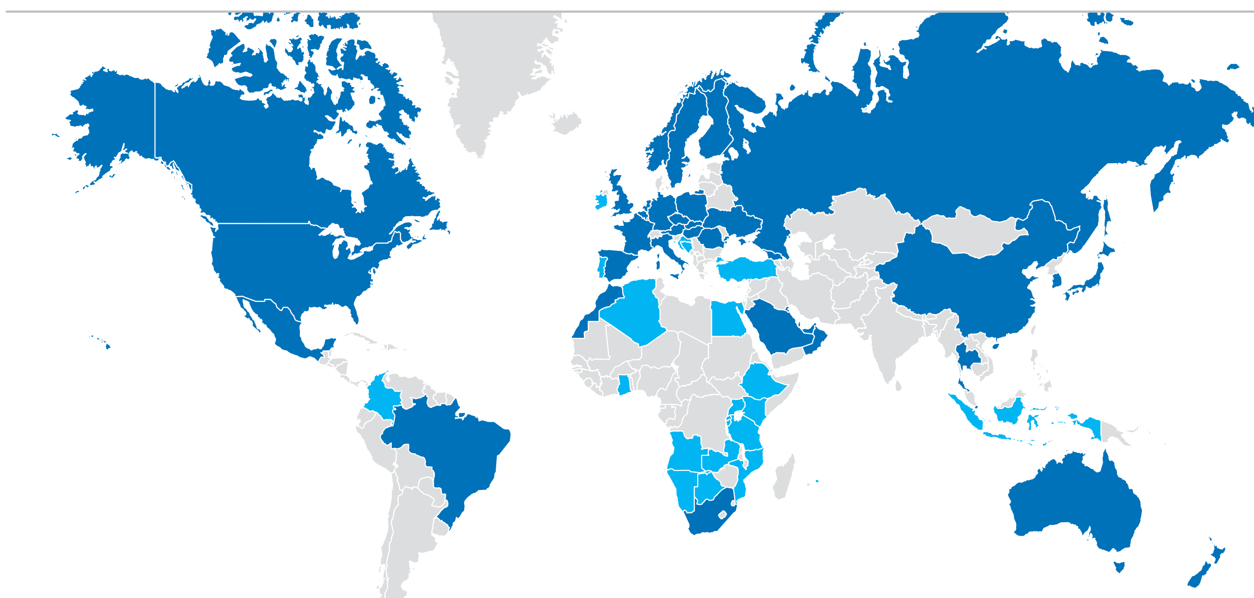

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