EMERGING THEMES 2015

Another turbulent year for financial regulation

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EMERGING THEMES 2015

Foreword

2015 is set to be another turbulent year for the financial services industry, especially for those working in UK banks. Few would disagree that there needs to be a significant improvement in banking standards or that bankers should be remunerated in a way that incentivises good behaviour and does not encourage excessive risk taking. The importance of maintaining confidence in the financial system cannot be overstated.

Reform of the Approved Persons regime is long overdue: the current arrangements are confusing and the regulators' expectations are unclear. However, the worry is that the pendulum may swing too far, with poor business judgment now criminalised and senior bankers effectively deemed guilty until they prove their innocence. Such measures, whilst no doubt popular, raise serious concerns in terms of due process and fairness.

Given the eventual likely extension of the new regime for senior bankers to other parts of the sector, everyone in financial services in the UK will be watching very carefully to see how it is implemented in practice.

This year's Emerging Themes contains the usual range of personal contributions by members of BLP's Financial Regulatory Group, which I am pleased to report has recently expanded to include our team of market-leading Competition lawyers. I hope you enjoy reading each of these articles.

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PRINCIPLE 3 - THE JOKER IN THE FCA'S PACK

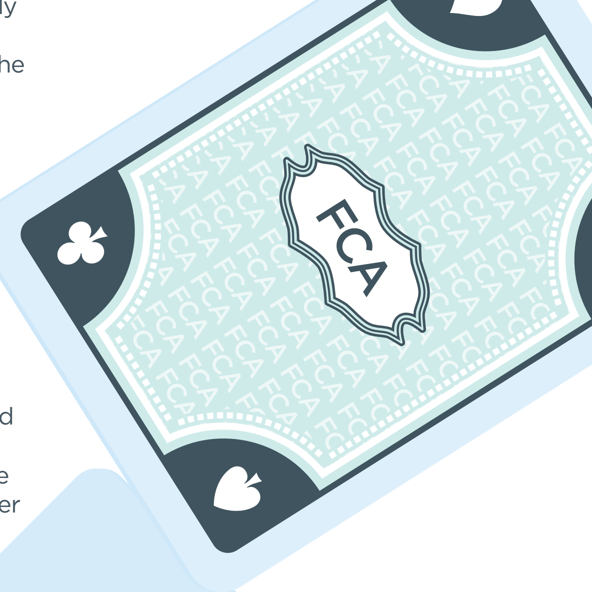
Irene Cummins recently represented a firm that was disciplined for breach of Principle 3; here, Irene shares her insights concerning the breadth of the regulator's jurisdiction under this Principle

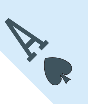
One case I handled over the last year involved FCA enforcement proceedings against a UK domiciled insurer relating to the outsourced sales of its general insurance policies to consumers in the UK and various EU jurisdictions. Because almost all of the activities under investigation had been carried out by third party outsource service providers rather than by the firm itself, Principle 3 of the FCA's Principles for Businesses ("a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems") was critically important to the FCA's case.

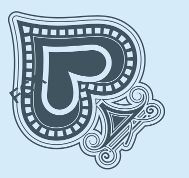
One of the issues at stake was the extent to which the FCA could bring enforcement action for breaches of Principle 3 in respect of sales that had taken place by third parties outside the UK. A separate bone of contention was whether the matters complained of by the FCA constituted regulated activities at all.

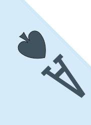
The FCA Handbook provides that, where the relevant activity is carried on "in a prudential context", Principle 3 applies to "unregulated activities", as well as regulated activities. It was on this basis that the FCA was able to bring enforcement action against several banks in relation to Forex trading, which was not a regulated activity. It also provides that Principle 3 applies to activities wherever they are carried on, rather than solely activities carried on in the UK.

This formulation seems relatively innocuous until you realise quite how broad the definition of "prudential context" in the FCA Handbook is. "Prudential context" includes "the context in which the activities have, or might reasonably be regarded as likely to have, a negative effect on" the ability of the firm to meet the "fit and proper" test in threshold conditions 2E and 3D (Suitability). Those threshold conditions provide that the matters which are relevant in determining whether a firm satisfies the 'fit and proper' requirement include, "Whether the [firm]'s affairs are conducted in an appropriate manner, having regard in particular to the interests of consumers and the integrity of the financial system [...]", and "Whether those who manage the [firm]'s affairs have adequate skills and experience [...]".





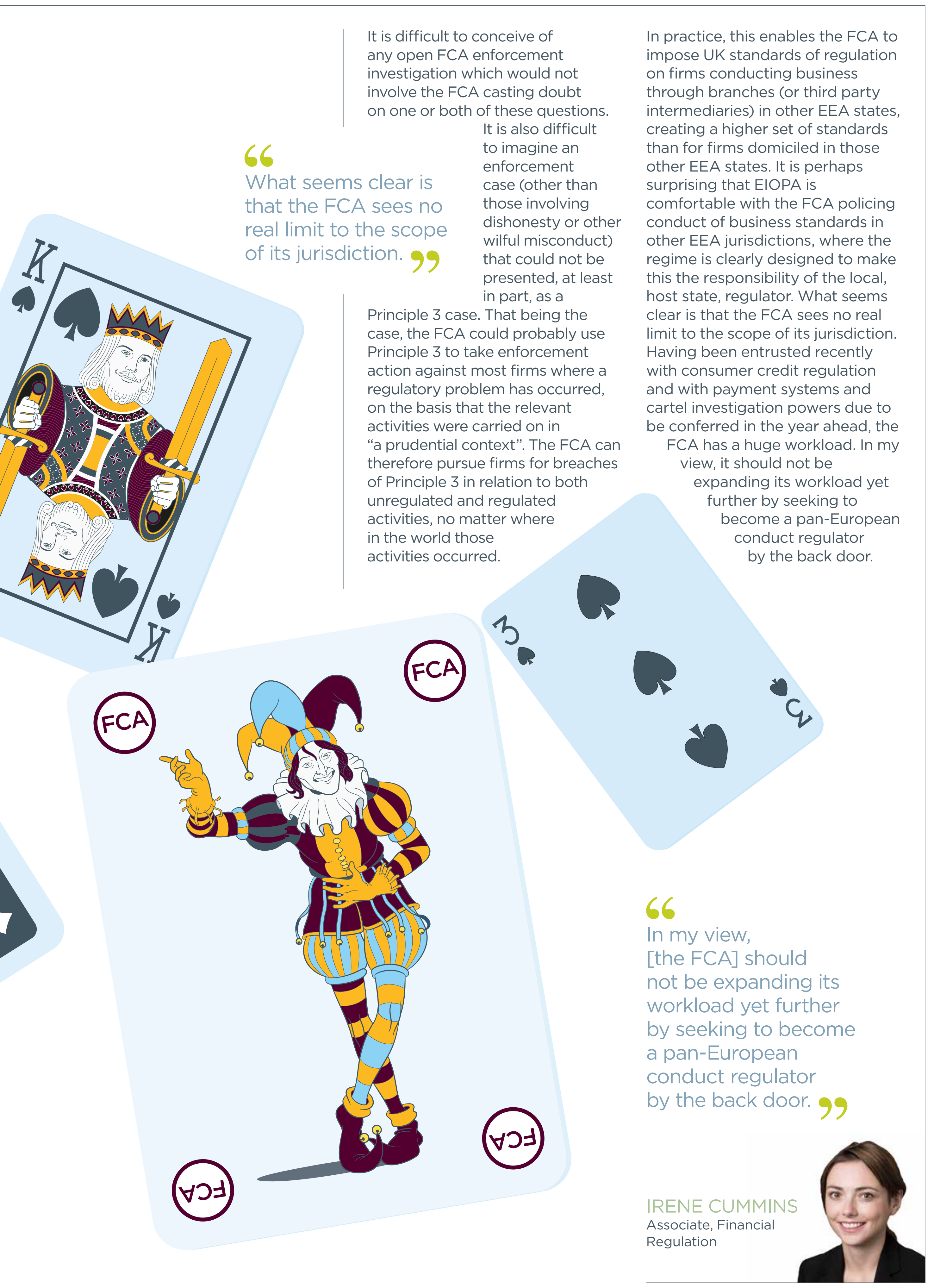




It is difficult to conceive of any open FCA enforcement investigation which would not involve the FCA casting doubt on one or both of these questions. It is also difficult to imagine an enforcement case (other than those involving dishonesty or other wilful misconduct) that could not be presented, at least in part, as a Principle 3 case. That being the case, the FCA could probably use Principle 3 to take enforcement action against most firms where a regulatory problem has occurred, on the basis that the relevant activities were carried on in "a prudential context". The FCA can therefore pursue firms for breaches of Principle 3 in relation to both unregulated and regulated activities, no matter where in the world those activities occurred.

> What seems clear is that the FCA sees no real limit to the scope of its jurisdiction.

In practice, this enables the FCA to impose UK standards of regulation on firms conducting business through branches (or third party intermediaries) in other EEA states, creating a higher set of standards than for firms domiciled in those other EEA states. It is perhaps surprising that EIOPA is comfortable with the FCA policing conduct of business standards in other EEA jurisdictions, where the regime is clearly designed to make this the responsibility of the local, host state, regulator. What seems clear is that the FCA sees no real limit to the scope of its jurisdiction. Having been entrusted recently with consumer credit regulation and with payment systems and cartel investigation powers due to be conferred in the year ahead, the FCA has a huge workload. In my view, it should not be expanding its workload yet further by seeking to become a pan-European conduct regulator by the back door.



> In my view, [the FCA] should not be expanding its workload yet further by seeking to become a pan-European conduct regulator by the back door.

IRENE CUMMINS
Associate, Financial Regulation

EARLY INTERVENTION ON THE RISE

The FCA is increasingly using its early intervention powers rather than waiting to launch formal enforcement proceedings; what does this mean for firms?

What is an early intervention?

Whilst early intervention is not a term that has been formally defined by the FCA, it has certain key characteristics focused on the FCA engaging earlier than usual and agreeing an appropriate response before damage is caused (or, at least to minimise the damage caused).

An early intervention can result in a wide range of actions, including use by the FCA of its powers under FSMA. The possible steps include: requiring firms to provide information 'here and now'; varying a firm's permission to remove certain permissions (either voluntarily through a 'VVOP' or by FCA's own initiative 'OIVOP' power); putting requirements on a firm's permissions (either voluntarily through a 'VREQ' or by FCA's own initiative 'OIREQ' power); commissioning skilled person reports; obtaining attestations from senior managers at the firm; banning financial promotions; placing a firm into administration or winding up proceedings; and/or obtaining a freezing/restraining injunction through the High Court where the firm is likely to contravene a requirement under FSMA.

Additional early intervention powers will be added as a result of the new Senior Managers Regime for banks, including the power to immediately suspend the approval of a Senior Manager.

While early intervention may involve formal action, in many cases it is more likely to involve a 'voluntary agreement' with the firm - frequently secured through a threat of formal action. It should also be noted that the use of its early intervention powers will not preclude the FCA from taking further enforcement action. When a significant issue is identified at a firm that gives rise to a risk of consumer detriment or damage to market integrity, the FCA is increasingly engaging with firms at an earlier stage than it (and indeed the FSA before it) had done previously. This new approach to regulation, which often involves both FCA supervisors and enforcement, is known as early intervention.

The FCA's annual report for 2013/2014 stated that the FCA used its early intervention powers 21 times over the course of the year. We anticipate that this figure will rise sharply in the year to come as the FCA seeks to establish a reputation for itself as a pro-active rather than a reactive regulator.

Recent example

A recent example of the early intervention strategy at work was the voluntary requirement (VREQ) entered into by the high-profile 'payday lender' Wonga in October 2014. Wonga agreed to a requirement to change its lending criteria to improve customer outcomes, appoint a skilled person to monitor its new lending platform and write off approximately £220m of customer debts. This came as a result of information received by the FCA that suggested Wonga was not taking adequate steps to assess customers' ability to make repayments in a sustainable manner.

> "Wonga agreed to a requirement to change its lending criteria to improve customer outcomes, appoint a skilled person to monitor its new lending platform and write off approximately £220m of customer debts."

Considerations and advice for firms

There are a series of issues that firms will need to consider in practice.

An early intervention may commence with an unannounced visit (or 'dawn raid'). Firms should ensure that staff are prepared for such an eventuality and have a suitable policy in place that sets out what actions should be taken in the event that the regulator turns up at the door.

> "In my opinion, co-operating with the FCA and voluntarily agreeing to a requirement, for example to pay redress, can often enable a firm to communicate a positive message to customers."

The wording of voluntary requirements and the terms of redress packages are negotiable and firms should be wary of signing up to requirements that are unduly, onerous or otherwise unfair. However, it is frequently the case that, given the threat of formal action by the FCA, the firm's room for negotiation may be limited.

Principle 11 of the FCA's Principles for Businesses requires that firms are open and co-operative with the regulator. I believe firms should keep this in mind when engaging with the FCA and co-operate so far as it is reasonable to do so. Building a positive relationship with the FCA is likely to assist the firm in the long run.

All in all, in my opinion, co-operating with the FCA and voluntarily agreeing to a requirement, for example to pay redress, can often enable a firm to communicate a positive message to customers, as well as better control and limit any adverse media attention and reputational damage that might otherwise have been caused. This needs to be weighed against the reasonableness and appropriateness of the measures that the FCA is asking the firm to agree.

More generally, the stage at which the FCA is considering the exercise of its early intervention powers can be a critical one for the firm and its on-going existence. As a result, it is critical to understand the regulator's priorities and what it is seeking to achieve, and engage appropriately and sensitively to identify an outcome that is acceptable to the firm and which achieves the FCA's desired outcome.

Adam Jamieson has recently returned from secondment to the FCA's Enforcement and Market Oversight Division.

ADAM JAMIESON
Associate, Financial Regulation

EARLY SETTLEMENT: A STEEPENING UPHILL STRUGGLE

Early settlement can be a double-edged sword; we look at the advantages and disadvantages for firms

What are the benefits of early settlement? "Early settlement is in the public interest. Settling an enforcement case early results in consumers obtaining compensation earlier than would otherwise be the case and saves resources for both the firm/individual and the FCA." This is the answer provided by the FCA and the basis upon which the FCA justifies its early settlement discount scheme. But the reasons for early settlement, as well as the benefits flowing from it, are very different from the perspective of the firm or individual involved.

The details of the discount scheme are set out in DEPP 6.7 of the FCA Handbook. In summary, the fixed discount scheme works on a sliding scale, depending on the timing of the settlement. Where the FCA and firm or individual in question "agree" a financial penalty figure (or a period of suspension/restriction) in principle, this will be reduced by the following proportions depending when the settlement is reached: (see graphic below).

No discount is applied if a settlement is not reached before the issuance of a Decision Notice.

There are clear financial benefits to a firm in settling early: not only the significantly reduced financial penalty, but also the reduced time and financial expense of having to go through the enforcement procedure. The firm also avoids a more forensic investigation into its business. However, the process can be unfair for a number of reasons:

1. Imposition by the FCA of strict settlement periods, together with delaying settlement negotiations until late in those periods, can mean that there is effectively no opportunity for proper resolution of important issues if the higher discount is to be obtained. The FCA fully understands the strength of its negotiating position and uses it strategically - and in my view - unfairly - to force firms to accept allegation(s) of misconduct and an unjustified level of penalty in order to benefit from the significant discount. As a result, the FCA has successfully pushed through very significant settlements even where its jurisdiction in relation to unregulated activities or events outside the UK are subject to significant doubt.
2. FCA enforcement negotiators do not have authority to agree settlement points - this lies with the Settlement Decision Makers, who are not directly involved in negotiations and may have limited availability to devote to the matter. This divorced authority is routinely used as both a delaying tactic and a basis for refusing to agree a settlement point in dispute where it would otherwise be unreasonable not to do so.

Reduction in penalty figure: FCA's enforcement process

Investigation

Preliminary investigation report

Submission to the FCA Regulatory Decisions Committee

3

Warning notice

STAGE 1
Settle before a submission is made to the FCA Regulatory Decisions Committee on the penalty.

DISCOUNT

STAGE 2
Settle before the expiry of period for making written representations to the RDC.

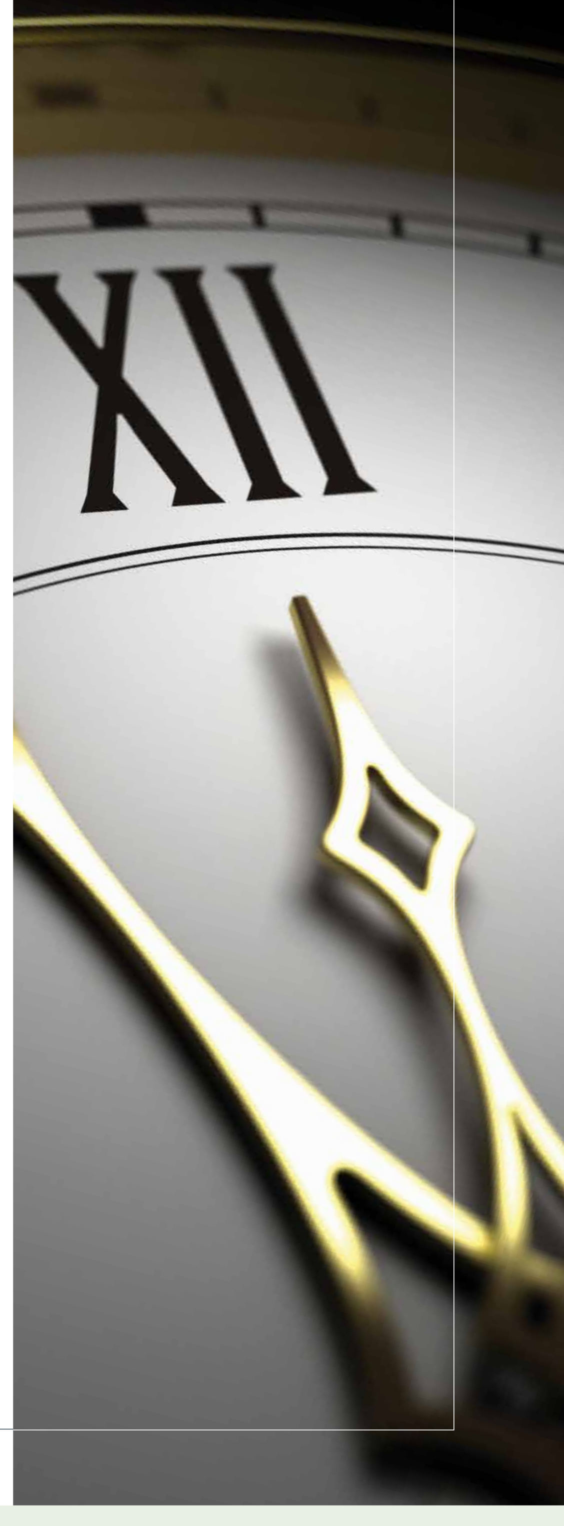
3. Where a firm accepts the FCA's findings in a Warning Notice, it cannot dispute the level of penalty imposed by the FCA without losing the early settlement discount. By way of example, if a firm challenges a £10m fine and the RDC reduces it to £8m, this is still more than the £7m the firm would have paid had it received the 30% early settlement discount on the original sum. Accordingly, a higher financial penalty can be incurred even where the RDC agrees that the fine was disproportionately high, since the 30% discount cannot be reinstated.

> "It will be interesting to see if, in 2015, the Treasury's controversial proposal to abolish stages 2 and 3 is implemented. I will be watching the FCA's consultation on this topic with interest."

The end of 2014 brought with it clear statements from the FCA's Enforcement Division that the regulator's intention is to focus not on whether firms have complied with the rules, but whether they have achieved the right customer outcomes. This perhaps provides further impetus for firms to settle early, even where they believe the assertion of a regulatory breach is unjustified, given the increased risk that the RDC will approach the rules in a different manner than the rules would suggest.

It also saw the Treasury publish its report into the enforcement decision-making process which provides some constructive suggestions to make the process fairer (such as regular updates regarding the status of the enforcement case). However, crucially, it also proposes to abolish stages 2 and 3 of the discount scheme - exacerbating the pressure on firms to settle within stage 1 and further skewing the balance of negotiating power in the FCA's favour.

For legal advisors, this can be difficult to swallow; for authorised firms themselves, even more so. It will be interesting to see if, in 2015, the Treasury's controversial proposal to abolish stages 2 and 3 is implemented. I will be watching the FCA's consultation on this topic with interest.



HELEN ARMSTRONG
Associate, Financial Regulation

Oral and written representation to the RDC (5) → Decision notice (6) → Upper Tribunal (7) → Tribunal's determination/ Court of appeal (8)

20% DISCOUNT

STAGE 3
The decision notice has been issued.

10% DISCOUNT

EU DATA REFORMS SET TO INCREASE REGULATORY BURDEN

Analysing the impact of proposed EU legislation in the area of customer data and network security

The European Union is close to finalising reforms to regulate the management of customer data and the networks it sits on.

There are two major EU reforms in the pipeline affecting customer data and network security. First, the draft Data Protection Regulation is designed to enhance the protections given to personal data and to harmonise data protection laws across the EU. Secondly, the Network & Information Security Directive is designed to create a base level of network and information security in all member states. It has a broader focus than the draft Regulation as it will protect wider categories of data, such as confidential business information, as well as the technological infrastructure that underpins much of modern society.

The draft Data Protection Regulation significantly widens the territorial scope of EU data protection law, making it clear that the new rules will apply to anyone offering goods or services to EU citizens or anyone who gathers information about the behaviour of EU citizens regardless, in each case, of where they are actually processing the data or are established.

The new rules will also strengthen requirements to obtain "explicit" consent to the processing of customer data. Importantly, there are no transitional provisions. This means that for consent to be a legitimate ground for processing, the data will have to be compliant as soon as the new rules take effect. It will not matter that when the data was originally gathered it was compliant. Therefore, although the new rules might not be in place for another two years, I believe that organisations need to be thinking now about changing their practices to obtain consent in a more explicit way and keeping records of how that consent was given.

For the first time under data protection law there will be a general obligation to notify regulators of a data security breach as well as the individuals adversely affected by that breach. This new obligation will need to be considered against other reporting obligations to other regulators and bodies, and coordinated where those obligations overlap.

The regulator in the UK for data protection will continue to be the Information Commissioner (ICO). However, the ICO will have substantially increased powers to fine organisations who breach the new rules. Under current law, ICO fines are capped at £500,000. Under the latest changes to the Data Protection Regulation, fines are set to increase to €100m or 5% of worldwide turnover (whichever is the greater). In the past, financial services regulators have often taken the lead in enforcement in view of their stronger sanctions. It is unclear what will happen in the future given the much higher fines available to the ICO. ➤

UNDER THE LATEST CHANGES TO THE DATA PROTECTION REGULATION, FINES ARE SET TO INCREASE TO €100M OR 5% OF WORLDWIDE TURNOVER.

> In my view, these reforms represent a radical shift in the way the EU regulates this area of risk.

Alongside the data protection reforms, the EU Commission has also put forward a new Directive on Network & Information Security. The Directive is designed to create a base level of network and information security across the EU. As well as setting standards for Member States to adhere to, it also has a direct impact on some undertakings critical to the operation of national infrastructure in the EU. These so-called "market operators" include credit institutions as defined in Article 4.1 of EU Directive 2006/48, that is an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account. Market operators also include "financial market infrastructures" defined as multilateral trading facilities, organised trading facilities and central counterparty clearing houses. Accordingly, large sections of the financial services sector will also be directly impacted by the Network & Information Security Directive.

The Directive requires market operators to take appropriate technical and organisational measures to manage risks posed to the security of their networks and information systems. There is also an obligation to notify new regulators, called "competent authorities", of incidents having a significant impact on the core services provided by that market operator. The competent authority can then inform the public or require the market operator to do so. It is unclear who will be the "competent authority" in the UK. The ICO has said it does not want to do it. There may therefore be a brand new regulator or the FCA might take on the role in relation to the financial services sector.

> Large sections of the financial services sector will also be directly impacted by the Network & Information Security Directive.

The Directive calls out for sanctions for non-compliance to be "effective, proportionate and dissuasive". They are as yet undefined, but I would expect them to be broadly in line with those provided for in the Data Protection Regulation.

Both measures have been scrutinised and passed by the EU Commission and the EU Parliament. They are currently under consideration by the inter-governmental EU Council. There is continued wrangling over certain provisions, including the so-called right to erasure, highlighted by the recent decision that the current Data Protection Directive envisages a "right to be forgotten" for individuals in relation to information which is out-of-date, inadequate or excessive.

In my view, these reforms represent a radical shift in the way the EU regulates this area of risk. They were initially put forward in 2012 and 2013 respectively, recognising that regulation needed to be modernised (the current Data Protection Directive dates back to 1995) and made fit for purpose for a world where Cyber-threats are common and increasing. They were spurred on by revelations regarding Edward Snowden in 2013. The level of fines are eye-watering, but perhaps of greater concern for me is the reputational risk around the mandatory reporting of incidents. As to when the reforms might be introduced, the latest EU Commission position was set out in letters issued in September 2014 by Jean-Claude Juncker (the new President of the EU Commission) to his nominees for Vice President for the Digital Single Market and for Justice. Mr Juncker tasked the new Vice-Presidents with pushing through the reforms within six months, that is by Spring 2015. If that happens then they will automatically come into effect approximately two years after publication, in 2017.

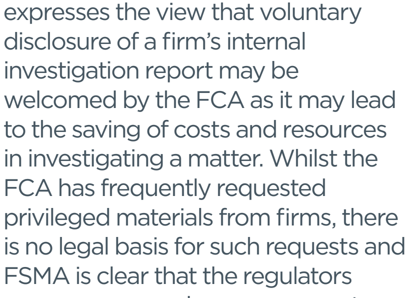
IAN DE FREITAS
Partner, Data Protection and IP

IT'S BEEN A PRIVILEGE

Sidney Myers and Andrew Tuson look at recent challenges to the fundamental right of privilege

An increasing trend in the FCA's enquiries and investigations has been to request the production of material covered by legal professional privilege. Whilst this material is protected as privileged at common law and also by statute under Section 413 of FSMA, the FCA appears to be taking an increasingly negative view of firms which rely on their right to communicate privately with their lawyers in order to seek legal advice but then refuse to disclose their communications to the regulator.

This trend is concerning. The common law right has been upheld by the courts as an inalienable one for centuries: everyone has the right to communicate frankly with a solicitor in order to obtain legal advice, without any fear that these communications may subsequently become discloseable (save, for example, where they are in furtherance of fraud). The courts have consistently found that there is no public interest argument to be made in going behind this basic right - even in a case concerning murder, the court has held that privileged communications where a suspect was alleged to have confessed to the murder should remain privileged and that there was no right to disclosure of these lawyer-client communications.



In its Enforcement Guide, the FCA expresses the view that voluntary disclosure of a firm's internal investigation report may be welcomed by the FCA as it may lead to the saving of costs and resources in investigating a matter. Whilst the FCA has frequently requested privileged materials from firms, there is no legal basis for such requests and FSMA is clear that the regulators have no power to compel their production or disclosure. However, the FCA has recently been taking a more aggressive stance in relation to the disclosure of privileged information, way beyond the position set out in the Enforcement Guide. For example, on case specific matters, the FCA has indicated that failure to disclose an internal investigation report produced by a firm's internal lawyers may constitute a failure by the firm to comply with its Principle 11 obligations to be open and co-operative with its regulators.

Similarly, through the FCA's controversial protocol for the interview of witnesses under which interviews conducted by a firm with its staff are to be recorded and the recordings passed to the FCA, we have seen further signs of the FCA seeking to interfere with a firm's right to have its lawyer conduct a review and provide privileged advice to the firm.

Why does the FCA want to see privileged material? Generally, the FCA will be interested in any concerns a witness has, or the facts explained by witnesses at the time of activity under investigation, or when first questioned, before a witness has the chance to reflect on the position or to take legal advice. As a result, notes of internal meetings with those involved in a suspected regulatory breach are a particular focus of attention from the FCA, on the basis that the information conveyed at these early meetings is likely to be a more complete or revealing account of the relevant events. The FCA has also expressed the view that it does not want to see individuals going to their lawyers and asking questions about how to get around a law or regulation, but wants to see individuals acting in accordance with the spirit of the law, or regulation and doing the right thing.

The FCA also appears to be taking the view that piercing through privilege is another way for it to assess and form a view about a firm's culture and approach to law and regulation.

In our view, the FCA's reasoning is misguided. Privilege is not a rule of evidence: privileged material should not be used to check what was or was not said. Privilege, as case law down the centuries makes clear, is absolute and its purpose is to protect the administration of justice. The courts have consistently taken the view that no-one should be deterred from telling the whole truth to their solicitor in order to obtain legal advice, and that no exceptions should be made to this fundamental right (save for the fraud exception we have mentioned). Whilst the courts see that there may be an occasional benefit in privileged material being disclosed in order to help deal with matters in dispute, the courts have consistently taken the view that this benefit does not justify the risk of someone being deterred from taking legal advice because of the risk that their communications may subsequently end up having to be disclosed.

The FCA now appears to be challenging this fundamental principle more aggressively. The regulator appears increasingly to be taking the view that those who refuse to provide material on the grounds of privilege must have something to hide. Firms and individuals should not be put in this position: Parliament has specifically protected the common law right to take legal advice and regulators should not seek to erode this basic legal right.

> "The FCA now appears to be challenging this fundamental principle more aggressively."

Where firms voluntarily provide privileged material to the FCA (or other agencies) in order to seek to avoid them taking the view that the firm is not properly co-operating, great care will need to be taken in relation to the material being provided. It is often difficult to confine a waiver of privilege to a particular issue. A waiver of privilege over one issue can frequently be said to extend to other related issues, which a firm may prefer to keep privileged. Further, and importantly, in the current regulatory environment, regulators frequently share material they receive (including privileged material) with other regulatory and investigatory agencies, so there can be no confidence that privileged material shared with one regulator will not be passed to other authorities, without a firm's prior knowledge or consent. This can be a particular risk where the material is acquired by a potential litigant. In short, once released, there can be no guarantee that seeking to impose restrictions on disclosure by the regulator, or assertions that the waiver of privilege is only partial, will protect the material disclosed from onward disclosure.

Whilst the FCA is a long way from adopting the approach taken by the European Commission, which does not recognise privilege in any communications with a firm's internal lawyers, the chipping away at the right to take legal advice is bound to lead to tensions in firms' relationships with the regulator. Heightened regulatory scrutiny makes it imperative that both individuals and firms should be free to take advice on their legal and regulatory obligations without fear that those communications will be disclosed. Regulators should recognise this and respect this fundamental right, as Parliament intended.

> "Heightened regulatory scrutiny makes it imperative that both individuals and firms should be free to take advice on their legal and regulatory obligations without fear that those communications will be disclosed."

SIDNEY MYERS
Partner,
Financial Regulation

ANDREW TUSON
Senior Associate,
Financial Regulation

REGULATORY CONTROL OVER INTERNAL INVESTIGATIONS

Firms are increasingly being asked to undertake detailed internal investigations by the FCA; we consider the implications

In recent years, I've seen a clear trend towards the FCA asking firms to undertake more detailed, lengthier internal investigations and to identify for themselves whether there have been any breaches of regulatory rules. If the matter proceeds to enforcement, the FCA will, of course, need to carry out its own investigative work and properly scrutinise the firm's findings. However, much of the heavy lifting will already have been done by the firm and inevitably that work product will shape the enforcement investigation to a large extent.

The corollary of this 'outsourcing' of investigative work is that the FCA is seeking to exert greater control over firms' internal investigations. The FCA is not alone in this regard; many regulators in different jurisdictions will expect to have their say as to how a firm should investigate and report issues arising in its business. This regulatory scrutiny can be challenging for firms.

To some extent, I think this trend was inevitable and borne out of expediency. The resources available to regulators have not kept pace with the massive scale of investigations we are now seeing, particularly in the wholesale sector. Huge, liquid markets such as interest rates and FX generate large volumes of data, and regulators need significant help from firms both to review and understand the material. The FCA already had an unenviable workload independent of these investigations, including a variety of market studies in the retail sector, wholesale sector reviews, its new consumer credit remit and preparing for concurrent competition powers in April 2015.

Another reason for the change might be political pressures to speed up the enforcement process. For non-settled cases, it takes on average over three years from the referral to enforcement until the decision notice by the FCA's Regulatory Decisions Committee, and significantly longer for the larger, more complex cases. This was noted in the recent Treasury Consultation reviewing enforcement decision making at the FCA and the PRA. There may be scope for the FCA to make the enforcement process quicker and more efficient if it has enlisted the firm's help to identify and isolate the nature and scope of any issues prior to referral.

> "This regulatory scrutiny can be challenging for firms."

When outsourcing investigative work to firms, the FCA will invariably still seek to exert some influence over the scope, speed, method and/or output of the investigation. For example, it may express views on which individuals' documents should be reviewed, which date ranges to focus upon, how a set of data should be reduced to a proportionate volume for review (eg the application of keyword searches and the choice of those keywords), the deadline for each tranche of an investigation, and the nature of progress updates and final reports (eg regular calls, presentations, written reports etc). Overseas regulators may also want to scrutinise the same issues, particularly if the relevant business area operates in an international market or if the overseas regulator adopts a broad view of its extra-territorial reach. The greater the number of authorities involved, the more exacting the requirements can be on firms as they may find themselves working to the tightest timetable and broadest scope demanded of them. The more proactive a firm can be in developing its own robust workplans, the more control it may be able to retain over the process.

One of the most controversial ways in which the FCA recently sought to influence internal investigations was the imposition of its "interview protocol". This two-page document set out a list of procedural rules to be observed by firms when conducting internal interviews. Most of the requirements were fairly standard and the sort of process points to which firm are already likely to adhere (eg offering regular breaks, asking open-ended questions, allowing the interviewee sufficient time to read documents etc). However, the protocol also included a requirement to record the interview on digital media and send the recording to the FCA within seven days (along with copies of any documents shown to the interviewee). This raised various concerns for firms.

First, a record of an internal interview may well be a "protected item" pursuant to section 413 of FSMA, which firms are not required to disclose to the FCA. Moreover, if a privileged record is disclosed to the FCA, there may be a risk of waiver under domestic or foreign law.

Second, from a practical perspective, such a requirement might obstruct the appropriate and necessary flow of information within a large institution. A recorded environment in which documents are read out to a tape may not be conducive to an open and frank discussion, and gives the appearance of a more hostile setting than a usual internal interview (more akin to a US style subpoena or a police interview). Interviewees may be more likely to insist on legal representation.

In fact, an interviewee might consider declining to attend such an interview at all. Attending an interview in those circumstances may result in the FCA being provided with direct evidence that could be used against the individual in a prosecution - both in the UK and overseas. This contrasts with information provided in a compelled FCA interview which cannot be used against the individual in criminal proceedings (see sections 171 and 174 of FSMA). Whilst an employee will typically have a contractual obligation to cooperate with their employer, they may seek to argue that those obligations do not apply if their effect is to override the employee's statutory protections.

Firms should be free to conduct meetings with their own employees to understand what actions have been taken by its staff and to respond appropriately. The increasing frequency with which the FCA is seeking to interfere with this right is, in my view, a troubling development.

"I believe that the relationship between firms and their supervisory regulators is of paramount importance."

Ultimately, I believe that the relationship between firms and their supervisory regulators is of paramount importance. Firms will have to deal with regulatory interference in their internal processes in the usual way; by engaging constructively with their regulators, explaining legitimate concerns where appropriate and reaching compromises insofar as possible. Regulators may be more receptive to concerns if firms have earned their trust, namely by proposing a meaningful workplan and then conveying the rigour with which they are undertaking it. Conversely, a firm could find itself subject to enforcement action if that trust breaks down.

ORAN GELB
Partner, Financial Regulation

IMPLICATIONS OF THE FCA'S NEW COMPETITION POWERS

Scrutinising the FCA's new competition powers as it becomes a concurrent competition authority and examining the effect they may have on firms

On 1 April 2015, the Financial Conduct Authority will become a concurrent competition authority with full competition investigation powers. On the same date, the Payment Systems Regulator (an independent body within the FCA) will gain concurrent competition powers for payment systems. Financial services firms - long used to FCA scrutiny under the Financial Services and Markets Act 2000 - will also face potential parallel competition law enforcement by the FCA. This will mark a significant shift from the current position.

What is FCA's remit today?

The FCA already has a primary duty to promote effective competition in carrying out its activities. It also has pre-existing competition powers. For example it can investigate markets which raise potential competition concerns and refer issues to the main UK competition regulator, the Competition and Markets Authority (CMA).

The FCA has a strong track record of using its competition remit. It has opened multiple market studies (insurance add-ons, cash savings, retirement income, credit cards) and has conducted "thematic reviews" of competition issues in various products.

What will change?

The FCA will be able - for "financial sector activities" - to enforce UK or EU law against anti-competitive agreements or abuse of a dominant position under the Competition Act 1998. It will also have enhanced market study powers under the Enterprise Act 2002.

The FCA will hold these powers concurrently with the CMA, meaning either the CMA or FCA can conduct a financial services competition investigation. Case allocation is determined by a set of rules and guidance protocols under which the "best placed" regulator will take a case. In practice, the FCA is likely to lead the large majority of financial services cases. The CMA will, however, retain the power to take over cases in some circumstances.

Are the changes significant?

The FCA will be able to conduct competition-based dawn raids, conduct compulsory interviews with witnesses, and compel production of relevant information. Competition law sanctions include penalties of up to 10% of worldwide turnover and director disqualification orders. The FCA will also be able to grant leniency to applicants, as well as potentially settling cases.

Individuals can also face criminal cartel charges. While the FCA cannot conduct criminal cartel investigations itself, the expanded nature of the criminal cartel offence - when combined with the FCA's increased competition powers - creates additional risks for firms to address.

The FCA's new market study powers will be more extensive than its current role. Market studies under the Enterprise Act 2002 are rigorous processes and the FCA will be able to accept remedies - for example voluntary divestments - to solve any competition problems identified.

Where the FCA cannot itself address any market features which have an adverse effect on competition, the FCA can refer the market to the CMA for a detailed "Phase 2" review. Market investigation outcomes can include compulsory divestment (e.g. BAA's forced sales of Gatwick and Stansted airports) and other sweeping interventions in commercial arrangements.

> Competition law sanctions include penalties of up to 10% of worldwide turnover

How do new powers reconcile with current FCA powers?

The FCA will have a duty to decide whether it would be "more appropriate" to use its Competition Act powers before using its regulatory powers under FSMA. Where the FCA proceeds under competition law, it cannot use regulatory powers. However, the apparently bright line between competition and FSMA enforcement may not be entirely clear-cut in practice.

What is the effect likely to be?

It is clear to me that the FCA will not sit idly on its new powers. The CMA reports annually on the effectiveness of the concurrent regime. Concurrent regulators are proactive in sharing competition expertise and information under the CMA's leadership. If the FCA is ineffective in applying its Competition Act powers, the government can remove those concurrent powers.

Taken together, I am of the view that these are powerful inducements that will surely result in a major uptick in financial services competition law cases.

How can I prepare?

Competition compliance procedures should be reassessed if they have remained unreviewed for some time. I believe that key factors include ensuring you have a robust dawn raid protocol (which includes provision for compulsory interviews), and considering criminal cartel risk in any arrangement with a competitor. Established market practices in various sectors may well need to be reassessed if they have the effect of distorting competition in those markets. Particular focus has been given to information exchanges between traders at competing firms, in light of recent investigations in the financial sector.

A "known unknown" is how the FCA's competition remit may complicate firms' Principle 11 self-reporting duty. As explored elsewhere in this publication, weighing disclosure obligations under Principle 11 in a possible cartel leniency decision raises issues of whether and when any Principle 11 reporting duty bites and how information should be handled. This relationship will need to be assessed carefully in each instance.

To my mind, the new powers add further complexity to financial services regulation. While the overall result is expected to be positive - for consumers, firms and, ultimately, UK plc - firms must ensure they are well-prepared to make the transition as seamless as possible.

JAMES MARSHALL
Senior Associate,
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CORPORATE CRIMINAL LIABILITY REFORM

Considering proposals to create an offence of corporate failure to prevent financial crime and its potential impact

The current Director of the Serious Fraud Office ('SFO'), David Green QC, has consistently called for reform to the law around corporate criminal liability. He has argued for the introduction of a vicarious liability standard (similar to that in the US) to enable the effective prosecution of corporates in the UK where an employee or associated person commits fraud, theft or some other financial crime on behalf of the company. There are now clear indications that the UK Government is looking to implement such a reform.

In a speech made on 1 September 2014 by the Attorney General, Jeremy Wright QC MP, to the 32nd Cambridge International Symposium on Economic Crime, it was indicated that the UK Government is now considering proposals to create an offence of corporate failure to prevent financial crime, akin to Section 7 of the Bribery Act 2010. The Attorney General noted that allegations of misconduct in the financial services industry have become too regular an occurrence, and that scandals such as LIBOR and the potential manipulation of foreign exchange rates have undermined public confidence in the integrity of key institutions and markets. Against this backdrop, the Government will shortly publish the first ever anti-corruption plan and it has made it a priority to ensure that the correct laws are in place to tackle fraud and corruption.

> "It is clear to me that an offence of corporate failure to prevent economic crime, if modelled on section 7, would widen the scope of corporate criminal liability very significantly."

The following day, David Green QC also made related comments in his speech to the Cambridge Symposium. Stating that the SFO is clear in its mission - to tackle the "top strata" of economic crime - Mr Green went on to re-iterate his support for a corporate offence of failure to prevent financial crime and noted that the idea is "gaining traction".

So what would this change to the law look like? Under the current law, companies can be fined an unlimited amount for failing to prevent bribery. Section 7 of the Bribery Act 2010 allows for prosecution of a corporate where any person associated with it - widely defined as those who perform services for or on behalf of the corporate - commits an act of bribery and the corporate does not have adequate procedures in place to prevent such conduct. This offence is wider in scope than the previous law and the common law, under which the prosecutor was obliged to prove that the "directing will and mind" of the company engaged in the relevant wrongdoing, a test which was considerably harder to meet.

It is clear to me that an offence of corporate failure to prevent economic crime, if modelled on Section 7, would widen the scope of corporate criminal liability very significantly and greatly increase the SFO's ability to pursue companies for the criminal actions of their employees or other associated persons.

However, it strikes me as potentially confusing to shoehorn such a broad offence into an Act which is meant to address bribery only. In addition, it is not at all clear to me that a "failure to prevent" standard is appropriate for other types of economic crime. If this idea continues to build momentum it will be important to identify what types of economic crime are proposed to be included, and whether the current formulation (which only attributes liability to the corporate where the bribery was carried out to obtain or retain business, or an advantage in the conduct of business, for the corporate) is retained.

AARON STEPHENS
Partner, Financial Regulation

COUNTING THE COST OF FRAUD

Fraud costs the Financial and Insurance sector £3.5bn a year – what can be done to stem the breach?

The latest Annual Fraud Indicator published by the National Fraud Authority reported annual fraud losses of £3.5bn in the Financial and Insurance sector - a shocking statistic but no real surprise to forensic accountants. Losses from fraud and financial crime represent a huge, but largely hidden, cost. It is estimated that, on average, losses from fraud account for between 5-10 per cent of a company's total costs.

Warning signs - So what should firms look for?

In my role as head of BLP's forensic team I have come across the following fraud risk indicators that have been apparent in a significant proportion of the fraud investigations that we have undertaken.

- Behavioural - look out for: (i) any obvious lifestyle changes, such as increased spending, that would seem out of line with the employee's salary; (ii) working unusually long hours or not taking holiday entitlement. This can be a sign that an employee is concerned about the fraud being discovered in their absence; or (iii) repeated complaints of workplace discrimination or harassment that appear groundless or vexatious.
- Transactional - examples include: (i) an excessive number of year-end transactions (such as manual accounting entries) to conceal fraudulent transactions among the flurry of other, genuine, transactions; (ii) excessive issuing of credit notes; (iii) clustering transactions just below payment authority limits; and (iv) the questionable use of suspense accounts.
- System - technology can be a fraudster's ally, but it can also be their undoing. IT programmes are ideally suited to monitor systems for suspicious activity, but they may not be set up to look for red flags such as: (i) log-in and system usage at odd times of day; (ii) use of non-corporate email accounts such as Hotmail; (iii) the introduction of unauthorised software or hardware into the system; and (iv) the exporting of data to non-corporate email accounts and hardware (eg data sticks and memory cards).

Protect yourself

And what can firms do to reduce the chance of being the victim of fraud?

The FCA's Guide to Preventing Financial Crime, which was published in April 2014, sets out some detailed, practical suggestions as to the actions that can be taken to counter the risk that firms might be used to further financial crime. This provides guidance on the type of effective systems and controls that can help to detect, prevent and deter financial crime. On the specific area of fraud these include:

- obtaining a thorough understanding of the firm's fraud risks;
- implementing readily accessible, effective and easily understandable fraud policies and procedures;
- preparing fraud response plans and investigation procedures;
- staff recruitment, vetting, training and remuneration; and
- using appropriate monitoring tools to identify potentially suspicious transactions

Summary

Fraud is a key risk faced by all businesses in the Financial Services sector. Whilst this risk can never be eliminated completely, being able to (i) spot the warning signs and (ii) implement appropriate systems and controls, will be a major step on the road to protecting your business.

PAUL BENNETT
Head of Forensic Services

THE FCA'S NEW CARTEL ENFORCEMENT POWERS

Considering the FCA's new cartel enforcement powers and assessing the potential legal issues and their practical implications for firms

As discussed elsewhere in this publication, the Financial Conduct Authority (FCA) will gain far-reaching competition law enforcement powers in April.

The combination of those powers and the FCA's existing regulatory powers will give rise to novel issues for firms that may have been involved in cartel conduct. The FCA will be unusual, if not unique, in a worldwide context in possessing both financial sector regulatory powers and competition enforcement powers. As with other sectoral regulators, the existence of competing policy objectives will create challenges both for the regulator and firms.

One area in which a particular tension may arise in practice, results from the juxtaposition of the leniency regimes applied by competition authorities in the United Kingdom and worldwide, and the disclosure obligations of firms under the PRA's Fundamental Rules and the FCA's Principles for Businesses.

Discovering possible breaches and considering leniency

There is no general obligation of disclosure on companies in respect of competition law infringements. If a firm becomes aware that it might have breached competition law, it generally has a choice: it may seek immunity or leniency from relevant competition authorities or, alternatively, it may decide to deal with the matter internally. However, UK regulated firms do not have the same freedom to determine their own response to discovering a breach of the competition rules.

The FCA's Principles for Businesses require regulated firms to deal with their regulators in an open and cooperative way. Firms must "disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice", including and any matter which has a "serious regulatory impact". Significant breaches of competition law, such as involvement in a price fixing cartel, may well breach several of the FCA's Principles for Businesses, including the duty to act with integrity; the duty to have in place adequate risk management systems; the duty to observe proper standards of market conduct; and the duty to treat customers fairly. Therefore, if a regulated firm becomes aware of a significant potential infringement of competition law, it is likely to have no choice but to disclose this information to the FCA/PRA.

Information provided to the UK regulators in this way can also be disclosed to other authorities via a number of statutory 'gateways', including where the disclosure is for the purposes of criminal prosecution. On acquiring concurrent competition powers, the FCA will become a member of the European Competition Network (ECN). If the FCA decides to open a cartel investigation, it will be required to notify the other ECN members (including national competition authorities and the European Commission) of its investigation without delay, and may share evidence with them, potentially triggering investigations by multiple authorities. Information and evidence may also be transmitted through the gateways to competition authorities and prosecuting bodies outside the European Union.

This may have a significant bearing on the decision whether or not to seek immunity or leniency in a given case. That decision is rarely a straightforward one for a company, and the interplay between compulsory disclosure obligations and leniency will further complicate the analysis. As always, time is likely to be of the essence in such cases.

Cartel investigations

Within the scope of its new competition powers, the FCA will be able to investigate and punish competition law infringements using a suite of tools substantially the same as those used by the Competition and Markets Authority (CMA). Its new powers include the ability to conduct dawn raids and compulsory interviews and to compel the production of relevant evidence. The FCA has entered into a Memorandum of Understanding with the CMA governing the co-operation between them, but many aspects (including in relation to leniency) are likely only to be worked out once the FCA assumes its new powers.

"Reflecting more general trends in UK competition enforcement, there are early signs that the FCA is already seeking to influence the way in which internal investigations are conducted by firms."

As for other UK sectoral competition regulators, the FCA must make use of its new powers or risk having them taken away. There are early signs that the FCA intends to deploy its new powers energetically. It has recruited a substantial team of competition specialists with extensive enforcement experience. The likely balance between the use of the FCA's resources to investigate markets and investigate individual instances of suspected misconduct is not yet clear. However, a novel feature of the regime will be the FCA's ability to use information obtained in the exercise of its regulatory functions to launch own-initiative investigations of suspected anticompetitive conduct.

Reflecting more general trends in UK competition enforcement, there are early signs that the FCA is already seeking to influence the way in which internal investigations are conducted by firms. For example, it may seek to attend interviews conducted by the firm's lawyers, and has recently sought to impose a specific method of conducting internal interviews at regulated firms that has given rise to concerns in relation to privilege and, potentially, self-incrimination.

Consequences - managing and mitigating risk

Alongside a potential need for strengthened competition law compliance procedures, firms may also find that the existence of the FCA's new powers results in a change in their relationship with the FCA.

In addition to challenges created by the interplay between compulsory disclosure and competition law, investigation procedures adopted by the FCA may give rise to complex legal and procedural issues, including in relation to the conduct of interviews of employees, potential criminal law exposure, and the risk of civil damages claims.

In a recent speech, FCA Chief Executive Martin Wheatley noted that that the FCA has "to bring competition thinking, as it relates to our objectives and remit, into every decision, in every rule, in every action we take". As we enter 2015 and the dawn of a new parallel set of responsibilities for the FCA, perhaps this sentiment applies as equally to regulated firms as it does to the regulator.

DAVID HARRISON
Partner, Competition

VICTORIA NEWBOLD
Associate, Competition

"Investigation procedures adopted by the FCA may give rise to complex legal procedural issues, including in relation to the conduct of interviews of employees, potential criminal law exposure, and the risk of civil damages claims."

THE NATIONAL CRIME AGENCY GETS TOUGH ON SUSPICIOUS ACTIVITY REPORTS

New guidance from the National Crime Agency sets out a new approach to SARs; we look at the possible impact

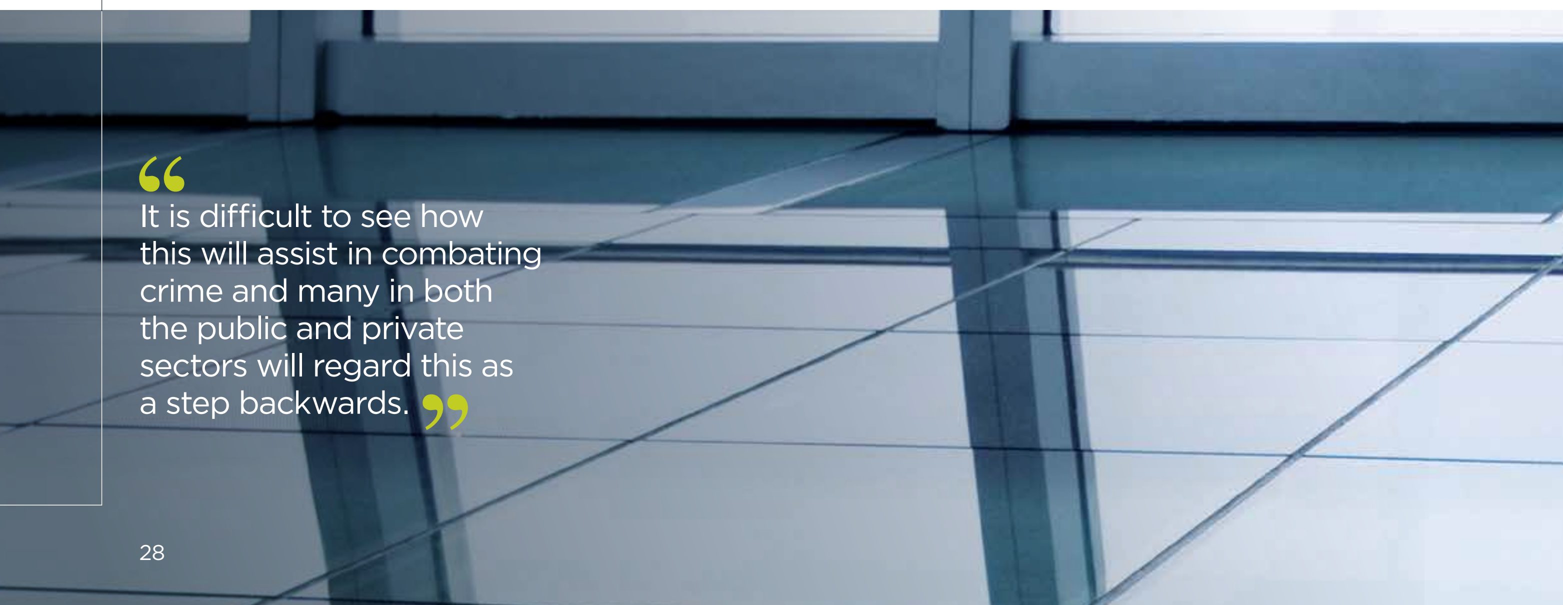
From 1 October 2014 the National Crime Agency (NCA) introduced guidance outlining a new approach to suspicious activity reports (SARs) filed under Proceeds of Crime Act 2002 (POCA), where consent to act is sought. In summary, any SAR which is deemed by the NCA not to contain a reason for suspicion or which fails to identify the nature of the criminal property "will be closed without further engagement". Thereafter, the reporter will be notified that the case is closed. Previously, the NCA had entered into dialogue with reporters to resolve matters.

The NCA maintains that a change in approach is required because of delays caused by the failure to include the following in consent SARs: the information or other matter which gives the grounds for knowledge, suspicion or belief; a description of the property that is known, suspected or believed to be criminal property; a description of the prohibited act for which consent is sought; the identity of the person or persons known or suspected to be involved in money laundering; and the whereabouts of the property that is known or suspected to be criminal property.

At first blush, the NCA's approach might seem uncontroversial. After all, the NCA can only provide consent to those who report suspicions in circumstances where the request for consent meets the conditions set down in POCA. In practice, however, as compliance and financial crime professionals will know, the consent regime is fraught with difficulties and this change has the potential to exacerbate problems.

The consent regime places a burden on firms and individuals in the regulated sector to submit SARs in circumstances where a failure to do so might give rise to criminal liability. In these circumstances, it is little wonder that Money Laundering Reporting officers err on the side of caution. The guidance issued by the NCA fails to recognise that in many instances, because of the wide definition of "criminal property" and the subjective nature of suspicion, consent requests are often complex in nature. For this reason, I believe that greater dialogue between the firm and the NCA may be appropriate and helpful to ensure a full understanding.

To illustrate how the change in approach may impact firms, consider a situation where a customer of a bank acts in a way which is suspicious and there is a concern that funds in an account may be tainted. The firm makes a consent SAR and freezes the customer's account, pending a response from the NCA. The NCA



> "It is difficult to see how this will assist in combating crime and many in both the public and private sectors will regard this as a step backwards."

then forms the view that the SAR does not satisfy its requirements and closes the case.

In a number of reported cases where firms have sought consent and frozen accounts, the firms in question have been able to defend themselves (in a claim for damages by the customer) by referring to the legal requirement to make a SAR and by asserting that it was unable to deal with funds on the account until consent had been received. In circumstances where the NCA asserts that the consent request is not in compliance with requirements, the bank would be unable to assert that it was complying with the requirements of POCA and would have no defence to a claim for damages brought by the customer.

A decision to make a request for consent under POCA is rarely taken lightly. The NCA's change in approach, however, it is likely to require firms to think very carefully about the nature of the suspicion and whether it is able to comply with the requirements.

> "Given the complexity of some of the issues that arise when seeking consent there will be a huge amount of pressure on individuals at the NCA who evaluate requests to get it right, and it would not be surprising if mistakes occur."

Given the complexity of some of the issues that arise when seeking consent there will be a huge amount of pressure on individuals at the NCA who evaluate requests to get it right, and it would not be surprising if mistakes occur. As such, in my view, the change in approach is likely to have a number of consequences.

Firstly, firms will increasingly seek external advice on the wording of consent SARs and advice on the extent to which a SAR is likely to be regarded by the NCA as an appropriate consent request.

Secondly, firms may need to challenge decisions made by the NCA. Many consent requests are not straightforward and in the event that the NCA has incorrectly rejected a request for consent and closed the case it may be appropriate to challenge the decision by way of judicial review. It is, of course, unlikely that firms will want to routinely seek to challenge decisions but a consideration of recent cases (for example, the Shah v HSBC Private Bank case where the bank faced a claim for damages of US$300 million) would suggest that firms may have no choice where it considers that a consent request has been wrongly rejected.

Finally, customers will seek damages in circumstances where an account has been frozen but where the NCA has refused to treat the SAR as a consent request and closes the case.

In the last 12 years there has been much debate concerning the consent regime and the pressure it places on those in the regulated sector in terms of potential criminal and civil liability. Throughout, law enforcement authorities have reiterated the importance of the public/private partnership. Definitions of 'partnership', however, usually contain a reference to cooperation, relationship and collaboration. The recent approach by the NCA seems to be the antithesis of 'partnership'.

The change in approach will require MLROs to be even more careful in ensuring that consent SARs tick all the boxes and it is likely, in relation to complex matters, that some firms will need to challenge decisions in judicial review proceedings. My view is that it is difficult to see how this will assist in combating crime and many in both the public and private sectors will regard this as a step backwards.

DAREN ALLEN
Partner, Financial Regulation

THE CONTINUING CHALLENGE OF THIRD PARTY RELATIONSHIPS

Looking at the difficulties third party relationships pose to firms when considering their Bribery Act obligations

Immediately after the Bribery Act came into force in 2011, it appeared that "tick-box" compliance regimes were widespread as firms rushed to be seen to be compliant. However, an emerging theme I have noticed in the last two years has been that firms have moved away from this approach and are increasingly committing to a "zero tolerance" attitude to bribery. In other words, over time, the Bribery Act has forced financial institutions to properly identify and engage with the bribery and corruption risks that they face. Commentary on the Bribery Act often focuses on the limited number of prosecutions to date, however, arguably the Bribery Act has already achieved its aims when you consider: the number of compliance officers being hired; the budget now available for anti-bribery and corruption compliance; the time spent by senior decision-makers considering bribery-related issues; and the resulting culture change which is sweeping through financial institutions.

However, as our clients commit to eradicating acts of bribery and other corrupt behaviour, I've found that they are becoming increasingly aware of the daunting scale of the task ahead. Creating systems and controls to mitigate bribery risk that are fit for purpose is a difficult and nuanced project. Last year financial crime compliance came of age; this year it has become battle-worn.

One area of particular difficulty is third party relationships. Regulatory interest in this area pre-dates the Bribery Act: the financial penalties imposed on Aon Limited and Willis Limited as early as 2009 were clear warning signs to the insurance industry and financial institutions generally that this is a particular area of risk. However, third party relationships were brought back into the limelight by the Section 7 Bribery Act offence which makes corporations liable for bribery by associated persons on their behalf.

> "Creating systems and controls to mitigate bribery risk that are fit for purpose is a difficult and nuanced project."

I take the view that third parties are problematic for the very reason that regulators are so interested in them. From a regulator's perspective, the fact that such parties are separate means that they can potentially be kept away from scrutiny and used as conduits for illicit behaviour, but from a firm's perspective this means they are difficult to monitor and control. Further, third parties are often conducting or engaging business for firms in countries where corruption is the norm.

Institutions face a further challenge because of the difficulty of raising awareness of the risks posed by third parties amongst their employees. In contrast, the City of London is aware of the risk that gifts and entertainment can be used as bribes. Indeed the squeeze on gifts and entertainment at all institutions means that even if your employees wish to lavish gifts on potential clients, it may be difficult to find someone willing to accept them. Hiring practices are next on the agenda following reports of the US authorities investigating the hiring of "princelings" in Asia in order to secure work from related parties. With the publicity around the arrest of senior figures, peer scrutiny of the background of new hires will make it difficult to hire on the basis of connections to key clients, and will therefore act as an effective, natural compliance control to the bribery risk.

However, third party risks are not always so well understood. Outside of compliance departments, employees may not find it easy to articulate the risks posed by third parties, nor do they always have the time or inclination to consider what their compliance regime is trying to prevent. Given the huge time and effort to identify and follow up on red flags in relation to third parties, and to ensure that they are acting appropriately and within the law, it is crucial, I believe, that firms' own employees recognise and engage with the risks as a first step.

The FCA fines of JLT Specialty Limited and more recently Besso Limited show that third party relationships are still very much on the regulators' agenda and continue to pose a significant challenge. Policies do not just need to be written, they need to be implemented robustly. Third party risks cannot just be communicated, they must be understood by those managing the relationships. Firms cannot implement a compliance regime and then forget about it - in both of the more recent Final Notices, the FCA refers to the fact that the firms' breaches were set against the backdrop of heightened awareness of bribery risk in general and the Aon and Willis penalties specifically. It is perhaps indicative of the challenges faced by firms that JLT Specialty and Besso had both been visited by the FCA and had therefore been alerted to the fact that their procedures were under scrutiny, yet were still not able to update their systems and controls to mitigate bribery risk to a satisfactory degree. As well as the risk of regulatory interest in anti-bribery systems and controls, there is also now the very tangible and headline-grabbing risk of prosecution under the Bribery Act if failed controls lead to actual instances of criminal behaviour. In this context, it is not hard to see why the compliance recruitment industry is booming.

But in light of the challenges in managing third party relationships, what does the future hold? The 2014 Dow Jones Anti-Corruption survey found that 67% of the compliance professionals surveyed stated that their company had delayed or stopped activities with third party business partners due to concerns over breaking anti-corruption regulation. Some insurance brokers may not have the luxury of choice. However, for other financial institutions, serious thought needs to be given to the use of third parties except where absolutely necessary. Outside the financial services sphere, it was interesting to see that one of Lord Gold's key decisions at Rolls Royce when he was brought in to review anti-corruption procedures was to reduce the number of third parties used. In other words, it seems to me that firms may start to consider de-risking altogether, where possible, by bringing outsourced services back in-house, and increasingly rely on the mechanisms in their policies and procedures to veto or terminate high-risk third party relationships.

JOANNA HARRIS
Associate, Financial Regulation

> Outside of compliance departments, employees may not find it easy to articulate the risks posed by third parties, nor do they always have the time or inclination to consider what their compliance regime is trying to prevent.

DRIVEN MAD BY GOOD INTENTIONS?

Whilst the pace is expected to increase on implementation of the Market Abuse Directive 2, we are still no nearer to getting clarity on many of the important issues

I wrote last year that 2014 was going to see further detail emerging on the implementation of the Market Abuse Directive 2 (MAD2) - a package of measure to reinvigorate and update the existing EU market abuse regime following the global financial crisis. As it happens, progress was slower than expected, in part because of the corresponding delays to the implementation of MiFID2. Instead, 2014 only saw the legislation entering the European statute book in June and the publishing by ESMA in July of two consultations on technical standards. MAD2 must be implemented across Europe by 3 July 2016. ESMA is required to issue finalised technical guidance in mid-2015 and so the pace may at last begin to quicken.

Two areas where there will be significant change from the existing regime are in relation to market soundings and insider lists. At first blush, these look like helpful developments. MAD2 incorporates a safe harbour against penalties for the disclosure of inside information where the disclosure is made as part of a market sounding exercise. This is particularly useful given the confusion in the market following the Greenlight/Einhorn fines in 2012. It also tightens up the requirements of the original Directive on insider lists. Under current proposals, the amount of information required to be contained in an insider list, and the requirements on their maintenance, are extensive.

Whilst the prevention of insider dealing and market abuse is in the interests of all market participants, my fear is that these changes (if implemented as currently expected) will result in more confusion and provide greater scope for firms and individuals to inadvertently breach their obligations, simply as a result of too much complexity. Under ESMA's current proposals, there are very detailed requirements on what firms must do in order to be able to take advantage of the safe harbour on market soundings. Whilst many firms already use scripts when calling potential investors, by including detailed rules on what must be included in scripts and what records need to be kept, even the most careful of firms may find that they cannot rely on the safe harbour due to administrative errors. Conversely, in its July consultation paper, ESMA stated that it had decided not to include guidance on what happens if a proposed transaction doesn't go ahead. In its earlier paper from December 2013, ESMA said that it would include rules on market cleansing. In the absence of guidance on market cleansing, there is likely to be a large amount of confusion and inconsistency in the market. The market urgently needs ESMA to step in during 2015 to provide clarity in this area.

MATTHEW BAKER
Senior Associate,
Investment Management

> Whilst the prevention of insider dealing and market abuse is in the interests of all market participants, my fear is that these changes (if implemented as currently expected) will result in more confusion and provide greater scope for firms and individuals to inadvertently breach their obligations, simply as a result of too much complexity.

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UNTABILITY

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STRENGTHENING ACCOUNTABILITY IN BANKING - A NEW FRONTIER FOR HR

The obligations proposed by the regulators in relation to individuals appear to be particularly onerous for bank HR teams; we examine the potential consequences

The far-reaching proposals set out in the PRA and FCA joint consultation paper "Strengthening accountability in banking: a new regulatory framework for individuals" overhaul the current Approved Persons regime that came in for so much criticism from the Parliamentary Committee on Banking Standards following the financial crisis. A new three-tier framework intended to make it easier for regulators and banks to hold individuals to account has major ramifications for banks' Human Resources teams and their interaction with other functions.

A new Senior Managers Regime will replace the current Significant Influence Function arrangements and apply primarily to Board and Executive Committee members and heads of key business areas and control functions. Such individuals will still need to be pre-approved by the regulators. In addition, banks will be required to submit a Statement of Responsibilities identifying the areas for which each Senior Manager is responsible. Banks will also need to produce and maintain a Responsibilities Map setting out their overall framework for the allocation of responsibilities to ensure there are no gaps in accountability.

A new Certification Regime will apply to employees who perform roles which are not Senior Manager functions but which relate to a bank's regulatory activities and which could pose a risk of significant harm to the firm or any of its customers. The onus of assessing and certifying the fitness and propriety of such individuals to perform their roles will shift from the Regulator to banks themselves. Banks will also have to undertake annual reassessment and formal certification. The number of individuals caught by this regime will extend significantly beyond those covered by the existing Approved Persons regime.

"HR will need to undertake a comprehensive review of contractual documentation and make it a condition of employment that Certification staff continue to be deemed fit and proper to undertake their role throughout the duration of their employment."

A new set of Conduct Rules will apply to all staff except those undertaking prescribed "ancillary" roles (including secretaries, IT and security staff and HR processors and administrators). The rules will apply to a significantly wider population than is currently covered by the Statements of Principle for Approved Persons.

These changes present various issues and challenges from an HR perspective. A high proportion of a bank's workforce will fall within the scope of the Certification Regime and/or the Conduct Rules. HR will need to be involved in defining and monitoring roles carefully to establish which roles fall within the Certification Regime and which are covered only by the Conduct Rules.

One of the most significant changes is that the regulators are now essentially outsourcing to banks the responsibility for assessing the "fitness and propriety" of Certification staff. Larger institutions are likely to require dedicated teams to set up and run this process. As well as ensuring that no staff perform a Certification function without being certified by the bank as fit and proper to do, banks will also be required to reassess the fitness and propriety of Certification staff at least annually before renewing their certification.

I anticipate that most banks will incorporate the certification renewal process into the annual appraisal process, in which case, annual appraisals will need to be undertaken in time to ensure the certification renewal takes place annually. The primary focus of the appraisal itself may well shift to an assessment of whether an individual is fit and proper to undertake their role. Will banks be able to certify employees as having the necessary level of competence if they have been awarded a low performance grade or identified as "Needs Improvement"? Similarly, where a disciplinary issue does not justify dismissal but nevertheless raises questions over an employee's fitness and propriety to undertake their role, banks may need to consider redeploying such employees into other non-certification roles. Where employees cannot be redeployed, there may be no alternative but to terminate their employment, which may result in legal claims from employees.

Accordingly, HR will need to undertake a comprehensive review of contractual documentation and make it a condition of employment that Certification staff continue to be deemed fit and proper to undertake their role throughout the duration of their employment.

It is also worth noting that any breach, or suspected breach, of a Conduct Rule by an employee to whom the Conduct Rules apply will be notifiable to the appropriate regulator within seven business days for Senior Managers or on a quarterly basis for other individuals. The regulator will also need to be notified of any disciplinary action taken in relation to the breach. HR professionals will need to be alive to the much greater scope for potential disciplinary issues to be reportable to the regulator, which in turn is likely to lead to a significantly increased volume of notifications being made.

HR personnel also need to be aware that banks considering appointing a candidate to perform a designated Senior Manager or specified significant harm function are likely to have to obtain references from any relevant authorised firm that has employed the candidate during the previous five years. Such references need to detail any notification to the Regulator of a breach of the Conduct Rules and/or the basis and outcome of any disciplinary action taken in relation to such breach whilst ensuring that any reference is true, accurate and fair. One does not need a crystal ball to foresee greatly increased scope for disputes in this area but there will be no way to avoid the obligation. The duty to disclose information relating to breaches of the Conduct Rules expressly overrides any agreement entered into by a bank and employee upon termination of the employee's employment. This could affect the current practice of providing an agreed reference as part of a settlement agreement, if this conflicts with a bank's obligations to provide complete and accurate information.

Finally, the proposed rules impose fairly onerous duties on firms to put in place sound arrangements for the handover of responsibilities to a new Senior Manager, to ensure that the individual taking on the role is fully equipped to fulfil his or her personal responsibilities.

Given the political will behind the consultation, we do not anticipate these proposals changing dramatically. Accordingly, HR teams need to be ready for this vast overhaul. At the time of writing, the government proposes implementing the new regime in mid-2015. We, and many of our clients, have strongly opposed such a swift implementation timetable as banks will need longer to understand and put measures in place to implement the new regime.

> "HR teams need to be ready for this vast overhaul."

ELEANOR PORTER
Senior Associate,
Employment

GENDER DIVERSITY AND EQUAL PAY

Equal work for equal pay? Considering the impact of gender diversity initiatives on the equal pay gap in the finance sector

Recent years have seen a number of initiatives encouraging employers to improve the gender diversity of their workforces and to tackle the equal pay gap. It has long been recognised that a diverse workforce is better for business and it is likely that a combination of legal requirements and voluntary initiatives will keep gender diversity high on the agenda for UK businesses, particularly those in the financial services sector. It is no longer enough just to pay lip service to gender diversity issues - businesses will need to be able to show policies are working and producing results in their organisation.

The financial sector has been singled out for particular attention on diversity and pay issues. This is partly because of the financial crash and lessons learnt, and also because the inequalities are particularly marked in this sector. In 2009 the Equality and Human Rights Commission carried out an Inquiry into Sex Discrimination and Unequal Pay in the Finance Sector. A Follow Up Report was published in 2011.

> "The financial sector has been singled out for particular attention on diversity and pay issues."

The Inquiry revealed a significant disparity in pay between women in the finance sector and their male colleagues. The gap was significantly wider than that in the economy as a whole.

The Inquiry delivered a number of key recommendations including: appointing a board member to drive change: implementing training: incorporating equality and diversity into objectives: developing non-discriminatory job descriptions and analytical job evaluations: undertaking annual equal pay audits and publishing the data: making sure maternity, paternity and parental support schemes are effective: and monitoring the implementation and effect of policy on gender equality.

A few years on, many organisations have adopted at least some of these recommendations. However, the expectation now is that some improvement will be made - businesses which do not see significant improvement are likely to come under pressure to do more.

The Follow Up Report highlighted the main issues which continue to contribute towards the disparities in pay such as transparency over base salary and benefits, the management of equality issues and the difficulties faced by those with caring responsibilities.

The pay gap has not been helped by the recent developments regarding bonuses and pay in the finance sector. Rules capping bonuses for certain financial sector staff have led to some businesses introducing allowances. However, the way in which allowances are determined means they will be open to the same challenges as bonuses. To avoid potential equal pay complaints, businesses will need to be able to objectively justify their pay practices and any pay disparities.

Transparency in pay is seen as a major factor in improving the pay gap. New legislation introduced in October 2014 requires Employment Tribunals in certain circumstances to order an employer to undertake an equal pay audit (EPA). The rationale behind this is that employers need to understand inequalities in pay in their organisation and have transparency of that information in order to address the inequality. An employment tribunal which finds that an employer has breached the equal pay provisions of the Equality Act 2010, must (subject to minor exceptions set out below), order the employer to conduct and publish an EPA. The only exceptions to this requirement are: where the employer has carried out an appropriate audit within the last 3 years; it is clear, without an audit, whether action is required to avoid equal pay breaches;

the breach found by the tribunal gives no reason to think that there might be other breaches; or the disadvantages of an audit outweigh its benefits.

I believe that the legislation will undoubtedly lead to an increased number of EPAs being carried out, whether by order of the Tribunal or by employers carrying out a voluntary audit to avoid claims or avoid being ordered to do so by a Tribunal.

The risk, and associated potential cost, of an EPA being ordered in gender pay discrimination cases is likely to become a key consideration for employers facing such a claim - particularly given that in most cases the results will have to be made public.

In my view, employers should consider exploring the pay profile within their organisations and potentially conduct a voluntary audit to determine potential legal or business risks. Identifying and remedying any areas of risk should, I think, help to minimise the

“In my view, employers should consider exploring the pay profile within their organisations and potentially conduct a voluntary audit to determine potential legal or business risks.”

possibility of equal pay claims and a compulsory, public EPA being ordered.

It is not just in the area of pay that we have seen developments. Recent years have also seen initiatives to increase the proportion of the number of women in senior roles. Lord Davies' report - Women on Boards (originally published in 2011) - set targets and put forward strategies aimed at ensuring more women were appointed to boardroom positions. The targets included 25% female representation on FTSE 100 boards by 2015.

Since Lord Davies' report was published, there has been significant progress, with the proportion of women on boards increasing. In March 2014, women accounted for 20.7% of board positions in the FTSE100 - up from 12.5% in 2011. In 2013/14 women accounted for 28% of all board appointments. It is likely that this momentum will continue and companies should be able to show that they have a clear (and open) strategy on how they intend to address any underrepresentation. Companies that don't approach this on a voluntary basis may find that they are required, by legislation, to take steps. The European Commission is currently discussing a draft Directive aimed at increasing the number of female non-executives on boards of listed companies. This includes a 40% minimum of the under-represented gender for non-executive directors. Also, the Equality and Human Rights Commission is conducting an inquiry into how FTSE 350 companies make decisions about the appointment of board directors and examining whether those recruitment practices are transparent, fair and result in selection based on merit. It will identify what improvements are needed with the aim of achieving better representation of women.

In my opinion, financial services businesses should take steps now to address gender diversity and equal pay. They should monitor and demonstrate progress in their organisation. If not, they risk exposing themselves to litigation, financial penalties and reputational damage. Businesses who do not tackle this issue head on will soon find themselves in a position where they are forced to do so in a way and on a timetable that is not of their choosing.

REBECCA HARDING-HILL
Partner, Employment

> “I also see some clear indications in the response that the FCA recognises that the use of attestations must itself be subject to good governance principles within the FCA.”

COULD YOU JUST SIGN HERE PLEASE...?

Senior individuals are increasingly being asked to sign attestations by the FCA; we look to see how these are being used by the regulator

One of the most frequent questions that senior managers and other approved persons ask is about the trends that we are seeing in the use of attestations. Unfortunately, the answer is that we are seeing them used more and more frequently.

In my experience, the FCA sees an attestation as a way of focusing a senior individual's mind on the issue in front of them. Being asked to sign your name to confirm a certain state of affairs, or that certain steps have been taken by the firm, requires the individual to be comfortable not only with the risk to the firm but also about the individual personal liability that comes with the attestation.

Recently, the increased use of attestations prompted Graham Beale, Chairman of the FCA Practitioner Panel, to write to Clive Adamson, then FCA Director of Supervision, to seek some clarity over the use of attestations as there was a perception that attestations skewed the prioritisation of risk within firms and resulted in negotiations over the framing of the attestation, rather than requiring the firm to give proper consideration to the underlying issue that may have prompted the request.

Mr Adamson's response, in August last year, makes it clear that attestations are here to stay and that the FCA sees a clear link between personal accountability and changing behaviours within regulated firms. However, I also see some clear indications in the response that the FCA recognises that the use of attestations must itself be subject to good governance principles within the FCA. The requirement for attestations to be approved by Heads of Department and implementing a centralised quality assurance method for all attestations seems to demonstrate that the FCA recognises that attestations cannot just become a shortcut in supervision by trying to attribute personal liability to senior individuals. Indiscriminate and unfocused use of attestations would ultimately lead to push back from senior managers, damaging their credibility, especially while they remain in the practitioner spotlight.

Used properly, in my view, attestations are a powerful tool in the FCA's supervisory powers and, along with the greater clarity of responsibilities that should be a product of the new Senior Managers Regime, will go some way to assisting with the change in cultures and attitudes that the FCA is seeking to bring about in the year ahead.

SARAH MCATOMINEY
Associate, Financial Regulation

WHISTLEBLOWING - INCENTIVISATION AND BEYOND

Whistleblowing remains high on the regulatory agenda. What can firms expect in 2015?

Whistleblowing remains a hot topic. Last year saw a raft of amendments to the UK whistleblowing regime which took effect from June 2013. However, the area remains in flux, with further reviews ongoing by Government, Regulators and the whistleblowing charity Public Concern at Work. Meanwhile, disclosures made in the financial services sector have continued to rise, with disclosures to the FCA having trebled since 2011, with a total of 1,200 claims expected in 2014.

One of the issues under review has been whether the UK should offer financial incentives to whistleblowers. This was a controversial proposal, explored in light of the introduction of a similar regime in the US. For now, this appears to have been ruled out. When the Department for Business, Innovation and Skills (BIS) responded to its Call for Evidence in June 2014, one key conclusion was that there would be no introduction of financial incentives. However, BIS did leave the door open for this to be reconsidered in relation to specific organisations or cases. It also highlighted that statements on the issue were awaited from the PRA and FCA.

If the BIS response left any uncertainty, the joint PRA/FCA publication of July 2014 makes it clear that they do not support the introduction of financial incentives in the financial services sector. This is based on their research, which identifies a number of flaws in such a system. Concerns include: the harm that large pay-outs would do to public perceptions of the sector; the risk of malicious reporting and/or entrapment; and also the risk that rewarding whistleblowers for performing what, for many individuals, is a regulatory duty, could undermine the function of the regulators altogether. Further, the experience in the US suggests that incentivising

> "Financial incentives may be off the table, but whistleblowing remains high on the regulatory agenda."

whistleblowers has not resulted in a significant increase in the number of reports, or in the quality of the reports made, anyway. The PRA and FCA therefore conclude that incentivising whistleblowers is not effective as a measure.

Financial incentives may be off the table, but whistleblowing remains high on the regulatory agenda. First, both the FCA and PRA have confirmed that they will start publishing annual reports on the disclosures they receive and the actions taken in relation to them. They committed to starting this process before the end of 2014. This is in line with the Government's own proposed amendments to the whistleblowing regime. The Small Business Enterprise and Employment Bill introduces a power for the Secretary of State to require "prescribed persons" (of which the FCA and PRA are two examples) to report annually on whistleblowing issues. The consultation on how this will work in practice closed at the end of September 2014. The reports are not intended to be detailed enough for firms to be identified; the proposal is for reports which show how many disclosures were received, the number of investigations that led to further action and other similar generic information. The reporting system has two goals: to ensure consistency across prescribed bodies; and to increase public confidence that the prescribed persons are taking the appropriate action.

The PRA and FCA have also accepted the Parliamentary Commission on Banking Standards' recommendations on whistleblowing and senior management accountability. These include a recommendation that a named non-executive, usually the Chairman, should be responsible for overseeing whistleblowing procedures and should be accountable if a whistleblower suffers a detriment. The PRA and FCA have said they will publish further, more detailed, proposals on whistleblowing imminently.

Finally, as well as implementing changes at an institutional level, both regulators are improving the way that they handle disclosures made to them. In October 2014, the PRA published a new webpage which sets out details of its approach to whistleblowing, how individuals can blow the whistle and what will happen if they do. Further, the FCA has doubled the size of its whistleblowing unit and both organisations are improving the way they track disclosures and support whistleblowers.

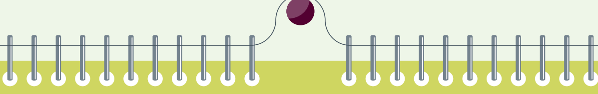
In our view, these measures ensure collectively that whistleblowing remains in the public eye, particularly in a sector which is still under considerable pressure to improve its internal accountability and reduce risk. With further publicity likely when the PRA/FCA proposals are announced, we believe that firms may well have both new regulatory requirements and an increased volume of disclosures to deal with in 2015.

LISA MAYHEW
Partner, Employment

JACKIE THOMAS
Knowledge Development Lawyer, Employment

KEY DATES:

EU and UK (2015 – 2016)



2015 - Quarter one

JANUARY 2015

1 January – FSMA 2000 (Ring-fenced Bodies and Core Activities) Order 2014 to come into force

1 January – PRA rules on bonus clawback come into force

1 January – Member States to apply the Bank Recovery and Resolution Directive

2 January – Price cap for HCSTC firms to be introduced

5 January – ESMA consultation on definition of commodity derivatives under MiFID II closes

6 January – PRA consultation (CP21/14) on changing insurance policy protection rules closes

January - FCA and PRA expected to publish policy statements on CP14/13 and CP14/14 (Senior Managers and Certification Regimes)

January - HMT to publish consultation paper on the extension of the RAO to binary options

FEBUARY 2015

February - EIOPA to publish Solvency II Set 1 Guidelines in all EU official languages

MARCH 2015

2 March – ESMA to deliver to Commission final technical advice on specification of procedures to enable reporting of infringements of MAR to competent authorities

2 March – ESMA to deliver to Commission final RTS and ITS on MAR

31 March – Solvency II transposition date

March - UK Government to finalise measures for implementation of Mortgage Credit Directive

March - FCA to publish policy statement on Mortgage Credit Directive implementation

EXPECTED DURING QUARTER ONE

- HMT likely to consult on implementation of MLD4 and Cyber-security Directive
- PRA expected to publish technical consultation paper on Senior Insurance Managers Regime
- PRA likely to publish feedback, final rules and final supervisory statements on the transposition of Solvency II
- FCA to publish policy statement on transposition of Solvency II (CP12/13)
- Mortgage Market Review rules (data reporting) come into force

2015 - Quarter two

APRIL 2015

April - Payment Systems Regulator to be fully operational

April - FCA's concurrent competition powers expected to come into force

April - Second charge mortgage firms can apply for mortgage permissions

JUNE 2015

26 June – Competition Commission's investigation into payday lending sector to have completed

June - CASS amendments (set out in FCA PS14/9) come into effect

June - HMT, BoE and FCA to publish recommendations on the way that wholesale FICC markets operate

EXPECTED DURING QUARTER TWO

- PRA policy statement on changing insurance policyholder protection rules expected
- PRA to consult on FSCS depositor protection reforms and publish final policy statements

> "It is disappointing that, both internationally and domestically, politicians and regulators are unable to resist the temptation to keep changing regulatory rules and procedures."

Nathan Willmott,
Partner, Financial Regulation

2015 - Quarter three

JULY 2015

1 July – CASS amendments (on client money rules for ISAs) come into effect

3 July – Deposit Guarantee Schemes Directive to be transposed by EU Member States

22 July – ESMA to issue an opinion on whether to activate the AIFMD passport for third country AIMFs/AIFs

July - PRA rules on insurance policyholder protection to come into effect

July - EIOPA to publish Solvency II Set 2 Guidelines in all EU official languages

July - PRA's depositor protection and policyholder protection reforms to FCSC to come into force

SEPT 2015

18 September – Payment Accounts Directive to be transposed into national law by EU Member States

EXPECTED DURING QUARTER THREE

- Bank Senior Managers Regime likely to come into force
- ESMA to submit final MiFID 2 RTS to Commission

2015 - Quarter four

OCT 2015

1 October – Liquidity Coverage Requirement to apply

22 October – Commission may activate AIFMD passport for third country AIFMs/AIFs

October - Consumer Rights Bill likely to enter into force

EXPECTED DURING QUARTER FOUR

- FCA expected to consult on MiFID 2 transposition

2016

1 January 2016 – Solvency II implementation date

1 January 2016 – Remainder of SRM Regulation and BRRD to apply

18 March 2016 – UCITS V to be transposed by EU Member States

21 March 2016 – Second charge mortgage regime to transfer to FCA mortgage regime from FCA consumer credit regime

21 March 2016 – Mortgage Credit Directive to be transposed into national legislation

31 March 2016 – Authorisation process for all consumer credit firms to be completed

1 April 2016 – Full FCA consumer credit regime comes into effect

3 July 2016 – The majority of the Market Abuse Regulation's provisions will apply

3 July 2016 – EU Member States to transpose CSMAD (except UK)

3 July 2016 –EU Member States to transpose MiFID II into national law

31 October 2016 – Non-euro countries to comply with SEPA Migration Regulation

31 December 2016 – PRIIPS ICID Regulation to apply in all EU Member States

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THE FCA'S WHOLESALE SECTOR COMPETITION REVIEW

The FCA is reviewing wholesale securities and investment markets, to identify areas where competition may not be working effectively. If such areas are identified, the FCA will conduct market studies in relation to them in 2015

The FCA is conducting a review of competition in the wholesale sector, in pursuit of its statutory objective of promoting effective competition in the interests of consumers (including business customers). The FCA's review, which focuses on wholesale securities and investment markets, is wide ranging, and covers activities relating to the "investment chain", namely markets and market infrastructure (such as clearing and settlement, and the production and dissemination of data), asset management (such as bundling of ancillary services), corporate banking and investment banking. The review excludes payment systems, credit rating agencies and wholesale insurance, and it will not focus on activities within the Fair and Effective Markets Review being conducted by the Bank of England, HM Treasury and the FCA.

The FCA is interested in any features of a market, or behaviour, that could inhibit the healthy functioning of competition in the relevant market. Examples of such features could include: barriers to entry or expansion; high levels of concentration; information asymmetries; conflicts of interest; principal-agent issues, such as misaligned incentives; high switching costs; and/or cross-selling or bundling of products and services.

Relevant areas for the FCA's review therefore include investment banking, asset management, equity underwriting, trading venues and clearing houses.

The FCA's review brings together the knowledge and resources of the FCA's recently assembled and sizeable team of competition specialists (including economists and lawyers), with its longer established teams of regulatory and sector specialists, in particular within the FCA's supervision and markets divisions.

The FCA intends to use the review to consider whether there are areas it should investigate further via a market study. The FCA has conducted several market studies in retail financial markets, including cash savings, retirement income products and general insurance (GI) add-ons, but has yet to launch a market study in a wholesale financial market.

The FCA expects to use market studies as its primary tool in relation to its competition objective, although from April 2015 it will also gain concurrent powers (ie parallel powers to those held by the UK's primary competition authority, the Competition and Markets Authority ("CMA")) to enforce the Competition Act 1998 and to refer markets for investigation by the CMA under the Enterprise Act 2002.

Firms and their advisers should bear in mind that the FCA can use the findings of a market study to impose a wide range of remedies, using its FSMA powers. Following the GI add-ons market study, for example, the FCA has proposed a combination of remedies, including banning the sale of GAP insurance at point of sale and requiring firms to publish claims ratios in relation to relevant insurance products. The time between initiating an FCA market study and implementing remedies can therefore be much shorter than in the case of a CMA market study and market investigation, which together can take over two years.

The wholesale sector competition review will enable the FCA to scrutinise a number of long-standing practices. The FCA will not need to prove that such practices involve unlawful collusion or the abuse of a dominant position: the market study regime is a flexible and potentially powerful tool, enabling the FCA to scrutinise and take action in relation to all the participants in a particular market, not merely against a dominant firm or specified competitors who may have been infringing competition law.

I believe that for firms active in wholesale markets, the FCA's review is a double-edged sword. Whilst it may allow firms to turn the FCA's spotlight onto areas where firms consider that they are getting a poor deal, for example in terms of market access, service levels, choice, and/or pricing, it could also allow firms' competitors, customers and suppliers to challenge those firms' own practices.

> I believe that for firms active in wholesale markets, the FCA's review is a double-edged sword.

Some of the markets under consideration by the FCA have come under previous scrutiny from competition authorities: for example, stock exchanges have been considered in the context of merger control investigations and the OFT has previously considered underwriting fees. But the FCA is now offering a fresh and more holistic look at a broader range of markets.

In my view, a key challenge for the FCA is to decide which issues to prioritise, from a very wide range of candidates. The FCA will be guided in this by the views it will have received from market participants, including the extent, content and seriousness of the submissions made about potential issues, as well as its existing institutional knowledge and experience.

Wholesale markets are much more international than retail markets. This means that one issue for the FCA to consider, both in identifying candidates for market studies and subsequently in conducting those market studies, is the extent to which the FCA, either alone or in combination with other regulatory and/or competition authorities, would be best placed both to conduct the relevant study and to remedy any issues identified by it.

It would be highly surprising, given the scope of the FCA's wholesale sector review, if no substantive issues were to emerge from it. I would expect to see at least two market studies launched by the FCA in 2015 in wholesale markets, as a result of the FCA's review, though I would hesitate to predict the subjects of those studies. Those market studies could then lead to significant regulatory intervention in the relevant markets, using (for example) the FCA's powers under FSMA to make rules, give directions and/or vary permissions. Such intervention could have dramatic consequences for the relevant markets and for market participants.

> In my view, a key challenge for the FCA is to decide which issues to prioritise, from a very wide range of candidates.

ADRIAN MAGNUS
Partner, Competition

A NEW REGULATORY OPTION? FCA LOOKS TO REGULATE BINARIES

The binary options market may be nearing regulatory certainty - what could be the impact for firms?

The binary options market is currently subject to a very confusing mismatch of regulation between the UK and much of the rest of the EU. Thankfully, this is likely to be resolved with a consultation paper expected to be issued by HM Treasury in early 2015. Binary options allow customers to predict two potential outcomes in financial markets. Unlike contracts for differences (CFDs), users win or lose a fixed return - they do not win or lose different amounts depending on how far the relevant price or index has moved at the relevant calculation point.

At present, the FCA does not regulate binary options as financial instruments. Instead, they are left to be regulated by the Gambling Commission. However, other EU regulators treat them as financial instruments that are subject to the Markets in Financial Instruments Directive. Whilst this imposes a regulatory burden on the binary options providers and intermediaries who are subject to that regime, the firms can at least benefit from the ability to provide services on a cross-border basis (or through a branch) into other EU jurisdictions. Not so for the UK market. Not only does the UK currently not allow these firms to become authorised by the FCA (and so provide services across Europe), but it also does not accept passporting applications from firms regulated elsewhere. That many firms offering binary options also offer financial CFDs (which are subject to FCA regulation in the UK) only serves to further confuse matters.

The UK has at last confirmed that it will fall into line with the EU. We do not yet have the detail of how the change will be achieved (and the consequences that will arise from that), however it is likely to involve a relatively simple amendment to the RAO.

I believe that it is possible that firms will consider re-domiciling into the UK to benefit from the FCA's regulatory regime and the ability to passport. For some firms, this will be their first formal venture into Europe. For others, there may be a move from one EU jurisdiction and regulator (in particular, Cyprus) to the UK.

In my view, firms should also consider what effect this will have on the rest of their business (for example, what compliance and reporting obligations will they have, and what regulatory capital would need to be held). They will also need to consider what, if any, effect this change will have on the enforceability of their contracts (since gaming contracts are not enforceable whereas contracts involving specified investments are) and on their and their users' tax position.

MATTHEW BAKER
Senior Associate,
Investment Management

REFORM OF BUSINESS INSURANCE LAW - A WORK IN PROGRESS?

Reform of business insurance law is long overdue; we take a look at the implications of the Insurance Bill for firms

The Insurance Bill is expected to become law during this Parliament and to come into force in April 2016 so insurers, brokers and policyholders should, I believe, wish to consider its implications now. The Bill is following the fast-track procedure for "uncontroversial" Law Commission Bills.

The Consumer Insurance (Disclosure and Representations) Act 2012 came into force in April 2013 and covered consumers, defined as "an individual who enters into the contract wholly or mainly for purposes unrelated to the individual's trade". The new Bill covers all other insurance.

Why reform the law?

The Bill has followed eight years of consultations and is long overdue. Indeed, reform was first mooted in 1957. There are several problems with existing insurance contract law for businesses, in particular:

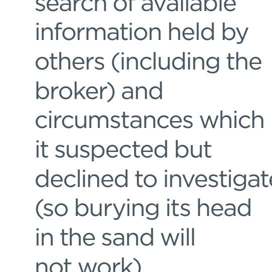
- it is archaic - much of it is based on the principles of the Marine Insurance Act 1906, long before modern computers were invented, let alone sophisticated risk modelling software and data systems. It simply does not reflect the vast amount of data now available to policyholders, brokers and insurers;
- it provides for a potentially disproportionate "all-or-nothing" remedy (non-payment of all further claims) for breach of warranty or the duty of disclosure, even where the breach is not relevant to the particular claim, leaving the UK out of step with other jurisdictions; and
- the courts have repeatedly tried to soften the letter of the law to bring about a just result in the circumstances presented to them and regulation has backed this up ("an insurer must not unreasonably reject a claim": ICOBS 8.1.1(3)R); however, these legal gymnastics have made the law unpredictable and given rise to myriad disputes on coverage and other issues.

Disclosure

Along with warranties, the classic duty of disclosure presents a real problem for policyholders. It is so onerous that policyholders do not know how to comply with it and it encourages insurers to sit back at inception stage, only asking questions at the claims stage.

The Marine Insurance Act 1906 principles require the policyholder to disclose to the insurer every "material" circumstance which the policyholder knows or ought to know before the contract is entered into. Section 18(2) provides that a material circumstance is "every circumstance which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk".

In reality, the courts have modified the strict duty by holding that if a policyholder makes a fair presentation of the risk which would prompt a reasonably careful insurer to make further enquiries, the insurer who fails to make such enquiries is deemed to have waived the information which such further enquiries would have revealed.



> "There are several problems with existing insurance contract law for businesses."

The Bill proposes a codified "duty of fair presentation of the risk", meaning disclosure by the insured/policyholder of:

- every material circumstance which the insured knows or ought to know; or
- failing that, disclosure which gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries.

The disclosure must be made "in a manner which would be reasonably clear and accessible to a prudent insurer" ie dumping of vast amounts of irrelevant data on the insurer will not be sufficient. The policyholder is deemed to know information which would be revealed by a reasonable search of available information held by others (including the broker) and circumstances which it suspected but declined to investigate (so burying its head in the sand will not work).

The relevant people within a business for the purposes of knowledge will be the organisation's senior management and those who participate on its behalf in the process of procuring the insurance, such as their broker. The Bill also provides some non-exhaustive examples of "material

circumstances” including “anything which those concerned with the class of insurance and field of activity in question would generally understand as being something that should be dealt with in a fair presentation of risks of the type in question”. The trouble with this catch-all is that it begs the question of what is generally understood. The Law Commissions urge the industry to develop guidance on this question but in the meantime, some uncertainty still remains.

Overall, the Bill’s provisions on disclosure are welcome. They codify the existing case law (which is worth doing on its own) and smooth over some of the rough edges.

“Overall, the Bill’s provisions on disclosure are welcome. They codify the existing case law (which is worth doing on its own) and smooth over some of the rough edges.”

Remedies for failure to disclose

The Bill provides that where the insurer can show that the policyholder’s breach of the disclosure duty is deliberate or reckless, the insurer will still be able to avoid the contract and refuse claims; and it need not even return premiums paid. Otherwise:

- if the insurer would not have entered into the contract on any terms, the insurer may avoid the contract and refuse all claims, but must return the premiums paid;
- if the insurer would have entered into the contract, but on different terms, the contract may be treated as if it had been entered into on those different terms; and
- if the insurer would have entered into the contract but would have charged a higher premium, the insurer may reduce proportionately the claim amount.

These new remedies are similar to those already introduced for consumers and should not come as a surprise to insurers.

The traditional duty of utmost good faith (which essentially reflects a duty of honesty and openness on the part of both the insurer and the policyholder) will remain but only as an interpretative principle. There will no longer be any specific remedy for breaching it. The Law Commissions believe that the principle will have three roles: (1) to interpret the new statutory duty of fair presentation; (2) to allow the courts to imply contract terms where necessary under the traditional “business efficacy” test; and (3) to give the courts flexibility in especially hard cases to prevent manifest unfairness, although the Law Commissions think that such cases would be “extremely rare”. This last point is somewhat inconsistent with the general thrust of the Law Commissions’ recommendations ie to avoid legal uncertainty, although perhaps it is unavoidable.

Warranties

The existing law allows an insurer to avoid liability for an inadvertent and trivial breach of warranty, even where it has been remedied and it has no relevance to a subsequent claim. The Bill abolishes “basis of contract” clauses (which converts statements into warranties) and provides that the insurer’s liability is restored if a breach of warranty has been remedied.

Remedies for Fraud

The Bill proposes a sensible clarification of the remedies for fraudulent claims. The insurer will of course have no liability for the fraudulent claim and will be entitled to recover payments already made in respect of it. The insurer will be able to treat the contract as terminated from the time of the fraudulent act and retain the premiums. However, terminating the contract does not affect or prejudice previous, valid claims.

I view the provisions as being generally sensible: they represent the evolution of the existing law, rather than truly radical change.”

Conclusion

Insurers and policyholders may agree to opt out of most of the Bill’s provisions (with exceptions such as the abolition of basis of contract clauses) but the insurer must take sufficient steps to draw the relevant term (which must be clear and unambiguous) to the policyholder’s attention. The Law Commissions want to discourage routine opting out although they expect this to be “more widespread” in sophisticated markets such as marine. This means that the Bill’s provisions will need buy-in from the market generally or they will simply not be used.

As a default regime, I view the provisions as being generally sensible: they represent the evolution of the existing law, rather than truly radical change. Meanwhile, the Law Commissions will continue lobbying for their recommendations on late payment and the remedies for breach of warranty relevant to particular losses (which are not included in the Bill). It therefore seems clear that we won’t need to wait another 100 years for further legislative changes to insurance law.

ADAM BOGDANOR
Partner, Corporate Insurance

INCREASING TRANSPARENCY IN STRUCTURED FINANCIAL PRODUCTS

Looking at the possible implications for issuers, originators and sponsors of structured finance instruments of new Regulatory Technical Standards in relation to disclosure requirements under the Credit Rating Agency Regulation

On 30 September 2014, the European Commission adopted Regulatory Technical Standards to implement detailed disclosure requirements for issuers, originators and sponsors of structured finance instruments under article 8b of the Credit Rating Agency Regulation. The Technical Standards set out the information which must be published, when it must be updated and how it should be presented.

Assuming that the European Parliament and the Council approve them, the Technical Standards will come into force 20 days after publication in the Official Journal and the disclosure requirements will apply from 1 January 2017.

The stated aim of the disclosure requirements is to improve investors' ability to make an informed assessment of risks relating to structured finance instruments, reduce investors' dependence and reliance on credit ratings and reinforce competition between credit rating agencies.

The requirements will not, however, just apply to a rated structured finance instrument but to any structured finance instrument which is issued after the Technical Standards come into force by an issuer, originator or sponsor which is established (has its seat) in the European Union.

A structured finance instrument is defined as any financial instrument arising from a "securitisation" under the Capital Requirements Regulation, ie. a financial instrument or other assets resulting from a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having both of the following characteristics: (a) payments in the transaction or scheme are dependent on the performance of the exposure or pool of exposures; and (b) the subordination of the tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

The disclosure requirements will, therefore, apply to all structured finance instruments resulting from a securitisation after the Technical Standards come into force - rated or unrated, public or private, listed or unlisted. These requirements are in addition to any disclosures which sponsors, originators and original lenders of structured finance instruments may already be required to make under other EU regulations, such as Article 409 of the Capital Requirements Regulation.

Issuers, originators and sponsors of all structured finance instruments within scope of the requirements will have to publish on a designated website (yet to be set up), copies of all the transaction documents and a transaction summary (if required) immediately after issuance of the structured finance instrument, along with two quarterly reports - a loan level information report (on a standardised disclosure template) and an investor report covering specified information.

There is, however, I believe, some good news for originators, issuers and sponsors of structured finance instruments in respect of the extra obligations.

First, they will be able to designate one or more of them to submit the information or may delegate to a third party (although they remain liable for compliance).

Second, the disclosure and reporting obligations will apply initially only to structured finance instruments which are not private or bilateral, which are issued after the Technical Standards come into force and are outstanding on 1 January 2017, and which are backed by the following underlying assets:

- residential mortgages
- commercial mortgages
- loans to small and medium-sized enterprises
- auto-loans
- consumer loans
- credit card loans
- leases to individuals and/or businesses ➤

All other structured finance instruments will be brought into the regime as soon as possible. ESMA will develop standardised templates and reporting standards for structured finance instruments backed by trade receivables, store cards and corporate loans, asset-backed commercial paper programmes, synthetic structured finance instruments, where the underlying assets comprise other structured finance instruments such as re-securitisations and structured finance instruments where the underlying assets are heterogeneous. All new templates will need to be adopted by the Commission through an amendment of the regulation.

Disclosure is also to be phased in for private and bilateral transactions. ESMA is to co-operate with stakeholders to specify to which private and bilateral structured finance instruments the standardised templates apply and to develop new standardised disclosure templates. ESMA will then propose amendments to the regulation for reporting requirements for such structured finance instruments.

Whether the introduction of these disclosure requirements will help the recovery of the securitisation market remains to be seen. However, I believe that there is a further opportunity for all stakeholders to have input into the remaining reporting templates and I hope that this further process will result in templates which work for all participants.

CATHY STRINGER
Knowledge Development Lawyer, Financial Products

"Whether the introduction of these disclosure requirements will help the recovery of the securitisation market remains to be seen. However, I believe that there is a further opportunity for all stakeholders to have input into the remaining reporting templates and I hope that this further process will result in templates which work for all participants."

THE ISDA RESOLUTION STAY PROTOCOL - A CLOG ON THE RIGHT TO TERMINATE

Tariq Rasheed considers the new ISDA Resolution Stay Protocol and its possible impact

The ISDA Resolution Stay Protocol came into effect on 1 January 2015. This protocol introduces a temporary stay on terminating, or otherwise enforcing rights, under ISDA Master Agreements (including any credit enhancement such as guarantees and credit support annexes) against a bank which becomes subject to a resolution action in certain jurisdictions (eg France, Germany, Japan, Switzerland, the United Kingdom and the United States). The resolution actions in other jurisdictions are likely to fall within the scope of the protocol in the future.

In my view, this is a significant change because the start of a resolution action ordinarily means the bank is insolvent (or is about to fail). Where this has triggered a termination right, such as an ISDA-standard Event of Default (eg Failure to Pay or Deliver, Cross-Default, Bankruptcy) and, furthermore, where the market positions at that time are in favour of the bank's counterparties, such counterparties have traditionally exhibited a willingness to terminate their outstanding transactions in order to crystallise their claims. Crucially, the counterparties' termination rights have not been subject to waiting periods imposed by foreign courts.

Depending on the particular jurisdiction, the duration of the temporary stay is between 24 and 48 hours. Where resolution action has been successful (eg the bank has been recapitalised, or acquired by a white knight), the counterparty will lose its termination right on the basis that it would face a creditworthy institution.

Although adherence is voluntary, regulators have secured the agreement of an initial 18 banks and certain of their subsidiaries for adherence. It is envisaged other banks and buy-side firms will subsequently adhere to the protocol as market acceptance for the protocol increases.

The initial 18 banks are Bank of America Merrill Lynch, Bank of Tokyo-Mitsubishi UFJ, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Mizuho Financial Group, Morgan Stanley, Nomura, Royal Bank of Scotland, Société Générale, Sumitomo Mitsui Financial Group and UBS.

The extent to which the temporary stay will affect the derivatives industry, both from legal and pricing perspectives, remains to be seen. I believe, for example, the margin period of risk may need to be increased and, therefore, banks may be required to hold additional capital.

TARIQ RASHEED
Partner, Financial Products

DUTY TO CONSIDER ECONOMIC GROWTH IN EXERCISING REGULATORY FUNCTIONS

Considering the implications of the Deregulation Bill's duty on the regulator to consider economic growth when exercising its regulatory functions

Clause 83 of the Deregulation Bill (in the form in which it reached the House of Lords) allows Ministers to require regulators to "have regard to the desirability of promoting economic growth" when exercising their functions.

The clause provides that the duty requires the regulator, in particular, to "consider the importance for the promotion of economic growth of exercising the regulatory function in a way which ensures that (a) regulatory action is taken only when it is needed, and (b) any action taken is proportionate."

This provision is very much in line with the current trend for legislation, which is designed more with an eye on headlines and party manifestos, than on the production of law which can be clearly understood and effectively applied. It is also in line with the fashion for sketching out a vague principle on the face of an Act, and leaving the details to be settled by a combination of secondary legislation and Ministerial back-of-an-envelope diktat.

In this case, there are two key questions: to whom will the duty apply, and what does the duty actually mean?

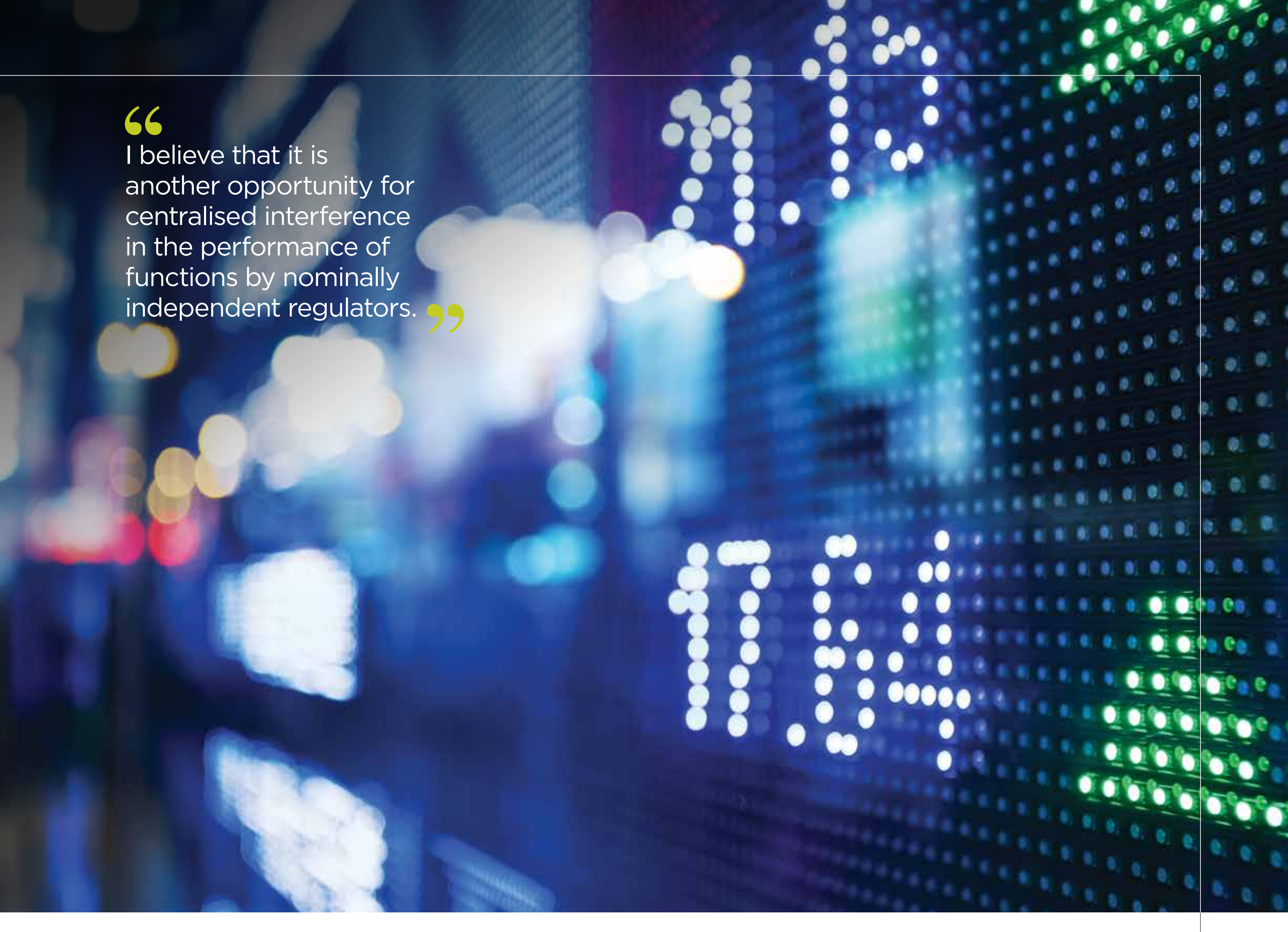
The first question is left to be determined by statutory instrument under clause 84. Ministers will specify the regulatory functions to which the duty applies. They have to consult with the regulators, but are not bound by their views. A specifying order will be subject to the affirmative resolution procedure, so Parliament will in theory have a chance to consider it - but the reality is that it is likely to receive only the most perfunctory scrutiny in either House (and, crucially, the Houses cannot amend it, so a list of specified functions will be presented to the Houses on a take-it-or-leave-it basis).

This provision is very much in line with the current trend for legislation which is designed more with an eye on headlines and party manifestos than on the production of law which can be clearly understood and effectively applied. ”

The second, and more important question, will be left to be dealt with in effect by Ministerial Guidance under clause 85, to which regulators will have a statutory duty to have regard. The guidance may set out "the ways in which regulatory functions may be exercised so as to promote economic growth" and "how persons who have the duty may demonstrate, in a way that is transparent and accountable, that they are complying with it". So the overall feel is very much that Ministers will tell regulators and others what is meant by this potentially highly significant duty from time to time in a quasi-legislative way. There is a statutory duty to consult in preparing the guidance; also, and very unusually for guidance, there is a duty to lay a draft before Parliament for approval before the guidance is formally made. This extraordinary requirement perhaps shows tacit acceptance that this is not something that should probably be being left to guidance at all, but goes to the heart of what (if anything) this duty will mean in practice.

Leaving aside general questions about the propriety of legislating using concepts that are more or less meaningless, and allowing Ministers to fill the gaps in meaning as they see fit from time to time by guidance, what are the likely practical implications of this duty in the regulatory field?

Most obviously, I believe that it is another opportunity for centralised interference in the performance of functions by nominally independent regulators. Given the breadth of the concepts of "promoting economic growth", restricting regulatory action to "when it is needed" and proportionality in the context of commercial or financial regulation, there is little or nothing that Ministers would not be able to squeeze into the concept as interpreted in accordance with their Guidance.



> "I believe that it is another opportunity for centralised interference in the performance of functions by nominally independent regulators."

Deliberate interference apart, the clause will inevitably make regulators more nervous of taking action in any area where it may plausibly be argued that the new duty is or might be relevant. If they are found to have taken insufficient account, or the wrong account, of the Ministerial Guidance in exercising their functions, their actions will be judicially reviewable and may be overturned, with the obvious financial and reputational consequences. Failure to act will become the safer option in an additional range of situations, and the primary regulatory purpose of the regulatory body - which will often be a matter of crucial public protection - risks being significantly undermined.

If I take the same point from an alternative perspective, the new clause will provide an additional ground for challenge of regulators' actions. The vagueness of the underlying statutory duty means that, depending on how far Minsters choose to widen the net in terms of which regulators to catch, and on how far they choose to stretch the meaning of the key terms, there should be significant scope for objecting to regulatory action, either before or after the event.

There is also the possibility that, despite its publicly deregulatory agenda, the clause will be used as grounds for forcing regulators to take action where they otherwise might not, if it can be argued that the action in some way promotes economic growth (which should not be difficult as the underlying concept is so vague).

In its draft Guidance published in January 2014 the Government says: "Economic regulatory functions will not be specified". This is not however, spelled out in the legislation, and there is no guarantee that a later Government will not seek to use this function to tell economic regulators what to do or not to do. Apart from anything else, there is the difficulty in determining precisely which bodies fall within the class of economic regulator. The economic regulatory sector will, however, be grateful for

what is, at least, an indication that for the moment they are likely to be spared from direct interference in this way. There are however, likely to be indirect effects on them, in a number of ways. In particular, there is bound (in practice) to be some sectoral read-across in the way in which economic growth is understood, and cross-contextual application of the statutory Guidance on the meaning of the term is likely to be irresistible: the argument will be that economic regulators are exempt - if they are - not because these issues do not apply to them but because they are already inherent and central to their statutory functions. More positively, it is possible that economic regulators may be able to use the clause and the Guidance indirectly to influence their fellows in other sectors so as to be more aware of economic growth issues for which the regulator has responsibility.

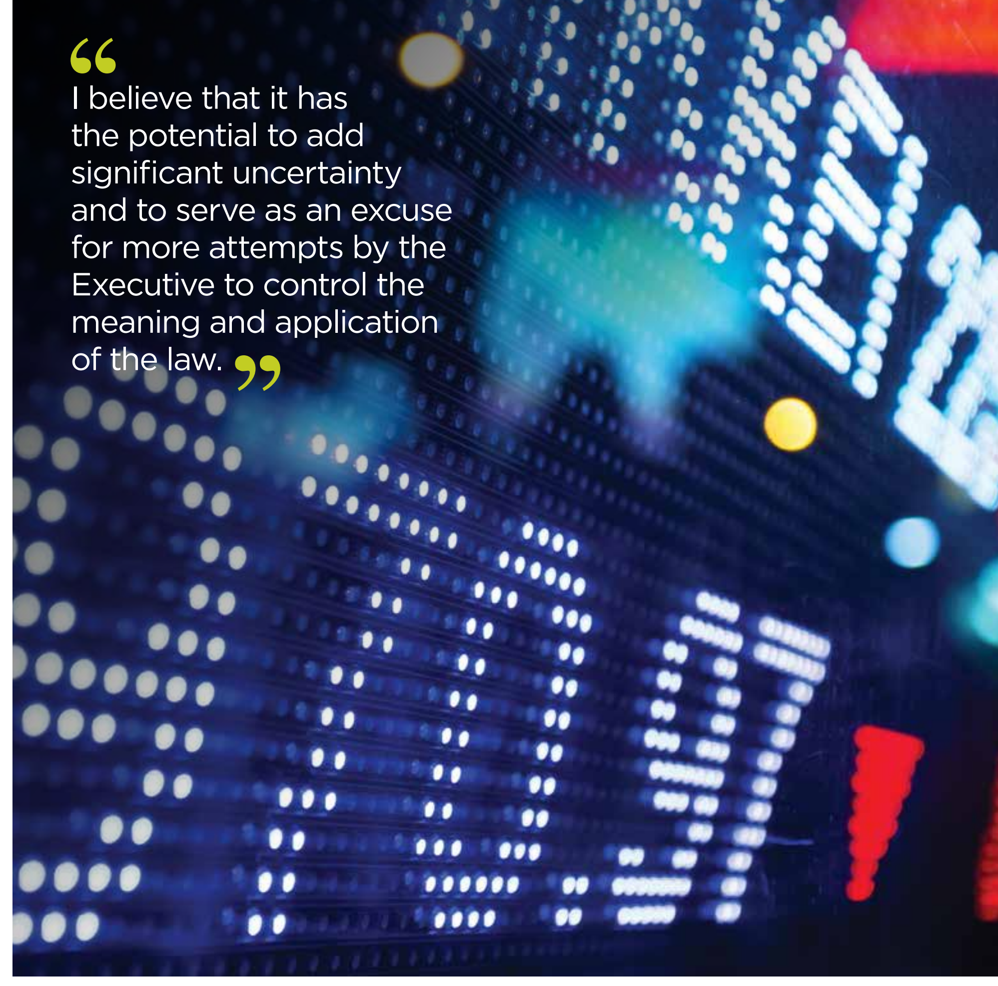
That apart, as I see it, the draft Guidance is woefully short of real detail or certainty: it is full of vague phrases such as "the growth duty requires regulators to consider and understand the scale and nature of that economic impact, within the bounds of what they can be expected to understand and what is proportionate in the circumstances". These phrases effectively rehearse the central uncertainties about what the requirement really means, without providing any useful clarity as to substance or process. This is only to be expected: presumably, if the Government had known with any certainty what they meant by this new requirement they could have said so in a couple of neat subsections in the clause itself, and not left it to Guidance in the first place.

When the Guidance attempts to descend to detail and to offer practical examples, it moves from the woeful to the ridiculous: for example, "Actions that a business might take which are indicative of growth include … starting the business …".

In introducing the Second Reading of the Deregulation Bill in the House of Commons, the Minister for Government Policy said, "The clause requires our non-economic regulators, every time they make a decision, to spend time and energy considering whether that decision takes proper account of the need for economic growth. That is not to say that that consideration should overrule all regulators' duties, but we are trying to create a sense of proportionality and to ensure that our regulators consider effects on growth as they go about their duties."

It is of course already a requirement of administrative law that regulators as public bodies ensure that their actions are proportionate and reasonable in every other sense, including taking into account all potentially significant consequences. So, taken at face value this clause will add nothing to the existing position. In reality, however, I believe that it has the potential to add significant uncertainty and to serve as an excuse for more attempts by the Executive to control the meaning and application of the law and the actions and policies of the bodies who are required to enforce it.

DANIEL GREENBERG
Parliamentary Counsel



"I believe that it has the potential to add significant uncertainty and to serve as an excuse for more attempts by the Executive to control the meaning and application of the law."

EU COMMISSION WEIGHS FATE OF COMPETITION SAFE HARBOUR FOR THE INSURANCE SECTOR

We consider the implications for insurers of the possible removal of the competition safe harbour

The insurance sector in the EU currently benefits from special treatment under the competition law rules, enjoying a safe harbour for common forms of pooling and joint underwriting arrangements and actuarial data exchange. However, this safe harbour protection under the European Commission's Insurance Block Exemption Regulation (IBER) has been the subject of consultation during the autumn of 2014, and its fate beyond March 2017 (when it is due to expire) lies in the balance.

The current IBER protects pooling arrangements for new classes of risk, which would otherwise not be insurable, irrespective of the market shares of the parties involved. It also protects jointly underwritten business for existing risks where the parties involved have combined market shares (typically judged on a risk category basis) below 20% in the case of co-insurance, and below 25% in the case of co-reinsurance, and provided that the parties remain free to underwrite business outside the pool. By falling within the safe harbour, the risk of regulatory sanction and unenforceability on competition grounds associated with an agreement is effectively eliminated.

Industry-specific competition block exemptions have fallen out of favour with law makers over recent years - leading, for example, to the abolition of EC safe harbours for motor vehicle retailing and liner shipping. Those sectors that have not yet lost their specific protections have generally seen a narrowing in scope of those safe harbours as part of a general move away from formalistic rules (and the legal certainty that entails) to an effects-based regime which requires self-assessment (with reference to the Commission's high level Guidelines and case precedent) by parties of potentially anti-competitive arrangements. Indeed, the current IBER is itself considerably narrower in scope than its predecessor, which expired in 2010. The previous IBER extended to agreements on standard policy conditions and security devices, but the Commission's view when contemplating its renewal was that such agreements are not unique to the insurance sector, and that their continued exemption under the IBER would therefore constitute unjustified discrimination against those other sectors which do not benefit from an industry-specific block exemption.

> "BLP and other respondents have argued for the retention of the safe harbour for the insurance sector, whether in whole or in part, given the greater degree of legal certainty it provides."

BLP and other respondents have argued for the retention of the safe harbour for the insurance sector, whether in whole or in part, given the greater degree of legal certainty it provides. We believe that this is particularly important in the context of increased competition enforcement in financial services generally, and in the UK in particular by virtue of a newly empowered Competition and Markets Authority, an activist Financial Conduct Authority with heightened competition enforcement duties and powers, and an explosion in parties privately enforcing competition law through the courts. BLP has also urged the Commission to update the definitions of exempt arrangements set out in the current IBER, to align them with the type of sophisticated broker-led schemes and facilities which have become a common feature of the insurance landscape over the years since the IBER was last revised. In short, this is an area destined for further scrutiny and change over the year ahead.

ANDREW HOCKLEY
Partner, Competition

CATHERINE WYLIE
Associate, Competition

MORE CHANGES AHEAD FOR THE MORTGAGE MARKET

The Mortgage Credit Directive is the next big thing on mortgage firms' agendas; we look at the possible implications

The ink is barely dry on the recent overhaul of the UK mortgage industry by the Mortgage Market Review and mortgage firms now have to face further upheaval through the implementation of the Mortgage Credit Directive. As Linda Woodall, FCA Director of Mortgage and Consumer Lending stated in a speech last November "regulation never stands still, and just when firms thought they could breathe a sigh of relief, along comes the Mortgage Credit Directive."

The Directive came into force on 21 March 2014 and is required to be implemented in Member States by 21 March 2016. The UK is aiming to finalise the measures needed to implement the Directive by March 2015 in order to allow the industry time to adjust to the new measures.

Notwithstanding the fact that the legal processes for registering title, enforcing loans and credit reference agency information are different in every Member State, the European Commission decided it was necessary to enact harmonised EU standards. For this and other reasons, the UK Government is "sceptical" about the value of the Directive which was subject to a great deal of negotiation by Member States.

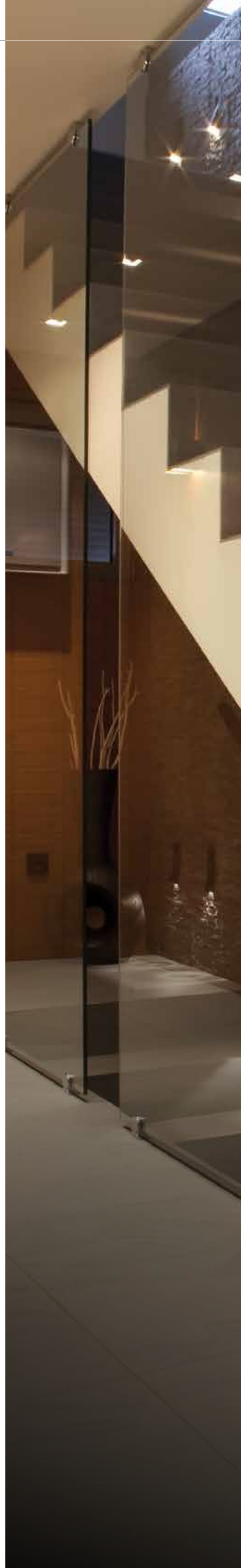
I find it commendable that in implementing the Directive, the government has promised to minimise its impact on the UK industry. The Directive lays down provisions subject to maximum harmonisation in relation to the provision of pre-contractual information through the European Standardised Information Sheet (ESIS) and the calculation of the annual percentage rate of charge and these will require changes to existing rules. It also sets out new rules in relation to second charge and buy-to-let lending, knowledge and competency, foreign currency mortgages and professional indemnity insurance. I, therefore, find it difficult to see how disruption and costs to firms will be insignificant.

In light of the UK's already stringent regulated mortgage regime, it is welcome for mortgage firms that the FCA will not have to change its existing rules on responsible lending, advice or arrears management.

The most controversial changes, and those that will affect an already heavily regulated industry the most, are discussed below.

In the field of buy-to-let lending, industry players and trade associations have reacted sharply to the proposals to bring the currently unregulated buy-to-let industry into a regulated framework. The UK Government is to introduce a new set of regulation where buy-to-let lending is to consumers rather than for business purposes. The Council of Mortgage Lending has expressed frustration that "despite earlier assurances, the buy-to-let position turns out not to have been adequately resolved".

The House of Lords EU Economic and Financial Affairs Committee wrote to the UK Government in



> I believe that it has the potential to add significant uncertainty and to serve as an excuse for more attempts by the Executive to control the meaning and application of the law.

November, expressing its concerns about the ramifications of the Directive for the UK buy-to-let market. The Committee pointed out that the Minister failed to provide any figures on the numbers likely to be affected, in particular among those forced into buy-to-let lending through inheritance of a property or an inability to sell.

Despite the concerns expressed, I would tend to agree with the UK Government that this should not affect the majority of buy-to-let lending which is done for business purposes. Most borrowers who make an active decision to purchase a property to let will be seen to be conducting a business activity. The consumer protections will likely apply to "accidental landlords" where the borrower is a landlord as a result of circumstance, ie those who have inherited or previously lived in properties and are unable to sell them so resort to a buy-to-let arrangement with their lender.

The Treasury's draft legislation allows firms to rely on a borrower declaration confirming that they are acting as a business, as long as there is no reasonable cause to suspect that the declaration is incorrect. Also, buy-to-let lenders and brokers will not be required to be authorised - they will simply have to meet certain minimum standards and register with the FCA.

As regards second charge lending, this will be moved from the consumer credit regulatory regime into the regulated mortgages regime from March 2016. Second charge lenders will have to put systems and controls in place to ensure compliance with most of the FCA's Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) including the rules in relation to disclosure, advised sales, responsible lending, contract variation, fees and dealing with customers in arrears.

Second charge firms will also need to apply for authorisation, and consider prudential requirements such as the prudential rules, the FCA's approved persons regime, data and complaints reporting obligations, the Financial Services Compensation Scheme and the Financial Ombudsman Service jurisdiction. I would strongly advise second charge lenders to start taking action to prepare for the new regime.

> I would strongly advise second charge lenders to start taking action to prepare for the new regime.

There will also be the headache of having to deal with back books of second charge loans in existence prior to March 2016 which are currently subject to the protections of the Consumer Credit Act. These will be moved to the mortgages regime but transitional provisions will apply so that certain consumer credit protections in place when the loan was taken out will not be removed retrospectively. These protections relate to disclosure of information, unfair relationships and the rules around the early settlement of the loan. Thus, second charge lenders will have to comply with a regulated mortgage regime as well as certain Consumer Credit Act protections for these back book loans during the transitional period.

Firms in the mortgage industry will also need to consider a series of other changes and ensure that appropriate systems, procedures, policies and training are in place when the new regime comes into force on 21 March 2016.

> I have no doubt that the Directive will have a major impact both in terms of costs and disruption, if firms do not review existing systems and procedures in good time before its implementation.

The ESIS will replace, and differs from, the FCA's 'Key Facts Illustration' from 22 March 2019. Firms can rely on this transitional period as long as they make certain 'top-up' disclosures (for example, in relation to the new seven day period of reflection) to enhance comparability.

The APRC will be required to be calculated in accordance with the mathematical formula set out in Annex 1 to the Directive. A second APRC will be required where interest or charges are variable.

The FCA proposes to require a compulsory pre-sale seven day period of reflection - the customer can accept the offer at any point during the reflection period.

The Directive requires Member States to establish knowledge and competency requirements for mortgage firms based around minimum requirements set out in the Directive. The FCA proposes to amend the high-level competency requirements in its Training and Competence sourcebook to ensure that those involved in the industry meet the Directive standard.

Finally, the Directive establishes principles for the authorisation and registration of credit intermediaries in conjunction with a passport regime for intermediaries.

I have no doubt that the Directive will have a major impact both in terms of costs and disruption, if firms do not review existing systems and procedures in good time before its implementation. Second charge lenders will be affected most, so it is imperative that they start planning immediately for authorisation, by reviewing existing documentation and systems and controls and considering how they propose to deal with back book loans. I would expect 2015 to be therefore a busy year for mortgage regulation.

EIMEAR O'BRIEN
Associate, Financial Regulation

ESMA GATHERS DATA FOR PROPOSED EXTENSION OF AIFMD PASSPORT

Examining the implications of a possible extension to the AIFMD passport to Non-EU Alternative Investment Fund Managers and EU Alternative Investment Fund Managers marketing Non-EU Alternative Investment Funds

The European Securities and Markets Authority (ESMA) launched a call for evidence on 7 November 2014 to gather input from EU and non-EU stakeholders on key issues that affect the anticipated extension of the Alternative Investment Fund Managers Directive passport to non-EU Alternative Investment Fund Managers (AIFMs) and to EU AIFMs marketing non-EU Alternative Investment Funds (AIFs). This starts the next phase of implementation for the Directive. Under the current regime, non-EU AIFMs and EU AIFMs of non-EU AIFs can only market their funds into member states where permitted by national private placement regimes. Private placement regimes involve a wide range of different, complex and in some cases still evolving requirements that may apply, depending on the circumstances. In my experience, these regimes are not always easy to access by AIFMs, particular non-EU AIFMs, and in some instances are acting as a disincentive to cross-border marketing.

ESMA will produce an opinion and advice (as required by the Directive) to the European Council, Parliament and Commission by 22 July 2015, having considered feedback gathered during this call for evidence. The opinion and advice will address: (i) the functioning of the management and/or marketing passport for EU AIFMs in respect of EU AIFs; (ii) the functioning of management and/or marketing of AIFs by non-EU AIFMs and EU AIFMs marketing non-EU AIFs using the private placement regimes; and (iii) whether or not the passporting regime should be extended to the management and/or marketing of AIFs by non-EU AIFMs and to EU AIFMs marketing non-EU AIFs.

If ESMA does give positive advice and opinion, the European Commission will then have up to three months, ie by 22 October 2015, to issue a delegated act specifying the date when the Directive's rules on the passport extension will apply. ESMA will not treat all non-EU countries as a single block, so only those that satisfy the criteria in the Directive will benefit from the proposed extension. The Directive envisages a dual regime operating from the introduction of an expanded passporting regime. This would mean that AIFMs to which the marketing passport could apply can either become authorised to use the passport or continue to use the private placement regimes (until, subject to ESMA's opinion, these are compulsorily phased out in 2018). There will therefore potentially be at least a three year period during which these AIFMs can access either regime, allowing them at this point more freedom in the way they market and manage their AIFs in the EU.

“There will therefore potentially be at least a three year period during which these AIFMs can access either regime, allowing them at this point more freedom in the way they market and manage their AIFs in the EU.”

CHRIS ORMOND
Knowledge Development Lawyer, Investment Management

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CONDUCT RISK - SMALL PHRASE, BIG IMPLICATIONS FOR INSURERS

"Conduct risk" is a relative newcomer to the regulatory lexicon. What exactly does the FCA mean by this term, and how does it apply to insurers?

You won't find "conduct risk" defined in the FCA Handbook Glossary, but the term has been in use by the UK regulators for some time. Looking back a few years, the FSA's 2011 Retail Conduct Risk Outlook viewed "conduct risk" as being "the risk that firm behaviour will result in poor outcomes for customers". At that time, the FSA viewed its retail conduct risk analysis work as a key aspect of its retail consumer protection strategy. For example, research that it commissioned into behavioural economics led to a concern that firms may be taking unfair advantage of consumers' behavioural biases, such as their tendency to favour the status quo. This in turn led to supervisors questioning the use, for example, of initial free periods to sell insurance products to retail consumers.

However, since the division of the FSA's regulatory responsibilities between the PRA and the FCA in 2013, the FCA's remit with respect to "conduct risk" has quietly, but dramatically, widened. When the FCA speaks of "conduct risk" now, it does so in the context of its statutory objective to "secure an appropriate degree of protection for consumers", with "consumers" now defined under FSMA 2000 to include any person who uses (or may use) regulated financial services, from consumers through to large corporate bodies; and its further objective of promoting market integrity. While retail customers remain important, the FCA is increasingly interested in the operation of the wholesale markets and the outcomes that commercial customers receive.

> "It is clear from the schedule of planned work set out in the FCA's 2014-2015 Business Plan that the FCA has its eye on a variety of conduct risks in the insurance markets, spanning both the retail and commercial sectors."

What then, under the new regime, is "conduct risk" in the insurance context?

What then, under the new regime, is "conduct risk" in the insurance context?

It is clear from the schedule of planned work set out in the FCA's 2014-2015 Business Plan that the FCA has its eye on a variety of conduct risks in the insurance markets, spanning both the retail and commercial sectors. For example, its planned thematic work for 2014-2015 includes a review of commercial claims handling (scheduled to have started by the final quarter of 2014), as well as finalising the work it had already begun in relation to the sale of premium finance to retail consumers alongside general insurance products. The announcement of this work plan was foreshadowed by Martin Wheatley, speaking to the General Insurance Conference in June 2014, when he said:

"Commercial insurance may not have quite the media 'pizazz' of retail... but it's clearly just as susceptible to conduct shocks."

The expansion of the FCA's conduct risk focus to include commercial policyholders in part reflects its concerns about so-called "wholesale/retail contagion", whereby retail consumers may be prejudiced by poor conduct in the wholesale markets as a result of complex distribution chains. As Tracey McDermott put it in a recent speech, the FCA had previously been "focussing on misconduct in the wholesale markets that disadvantages retail consumers". The FCA now views poor conduct in the wholesale markets as a matter affecting the level of trust in those markets, which in turn brings into play another of its statutory objectives: to protect and enhance the integrity of the UK financial system. As the FCA explains in its current Business Plan, poor behaviour in relation to commercial claims handling "could have a wider impact on trust in the market, as well as leading to poor customer outcomes". That is why conduct risk has become so important.

The FCA's published policy in relation to examining conduct risk in the wholesale markets is borne out by our own experience of the regulator's supervisory activity over the past year. We have seen the FCA taking a particular interest in the types of product that span the wholesale and retail divide: for example, providers and distributors of group policies where the end consumer may be a retail consumer, but the immediate consumer is a purely corporate entity. But we have also noticed the FCA showing a far keener interest than the FSA ever did in commercial, rather than retail, lines.

“The FCA's published policy in relation to examining conduct risk in the wholesale markets is borne out by our own experience of the regulator's supervisory activity over the past year.”

“It is clear that identifying and managing conduct risk has become, in the regulator's mind, a matter that is central to the re-building of trust in our financial institutions.”

It is clear that identifying and managing conduct risk has become, in the regulator's mind, a matter that is central to the re-building of trust in our financial institutions. Insurers will therefore increasingly be asked to demonstrate to their FCA supervisors that, to quote the FCA's Business Plan, they have "adopted a holistic approach to identifying and mitigating the conduct risk arising from their activities". This will include the need to have tangible evidence, at Board level, of the fact that the insurer's policies are providing valuable and appropriate protection to policyholders in relevant target market(s). The following actions are likely:

First, a review and re-structuring of firms' governance frameworks, for example to include a specialist conduct risk committee with delegated responsibility for proactively identifying and managing conduct risks within the business – spanning commercial lines as well as retail business;

Secondly, a review of firms' risk management functions, to ensure that conduct risks are adequately measured within the overall risk management framework;

Thirdly, a sound internal process for assessing - on the basis of cogent evidence - whether the scope of cover provided by each of the insurer's policies is appropriate for the target market and therefore providing valuable protection to those who are policyholders; and

Finally, implementation of new processes for the collection and reporting of conduct risk management information at a sufficient level of granularity to enable firms' governing bodies to monitor and control each of them effectively.

POLLY JAMES
Senior Associate,
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WHAT CAN WE EXPECT FROM THE PAYMENT SYSTEMS REGULATOR?

The Payment Systems Regulator is the new kid on the block. How will it make its mark over the coming year?

The Payment Systems Regulator (PSR), a new competition-focused economic regulator for designated UK retail payment systems will become fully operational from 1 April 2015. Part 5 of the Financial Services (Banking Reform) Act 2013 gave the FCA the power to establish the PSR, as a subsidiary of the FCA, in order to address issues which have troubled the industry for a number of years, including competition, innovation and service-user responsiveness.

The PSR will regulate certain payment systems that are designated by HM Treasury following the consultation which closed in November 2014. Once designated, each regulated payment system's "participants" (ie infrastructure providers, operators and payment services providers) will fall within the PSR's scope. Designated systems are likely to include: Bacs; CHAPS; Faster Payments; LINK; Cheque and Credit; Northern Ireland Clearing; Visa and Mastercard.

The PSR has three statutory objectives. These are:

1. the promotion of effective competition in payment systems and the services they provide;
2. the promotion of innovation; and
3. ensuring that payment systems are operated and developed in a way that takes account of, and promotes, the interests of service users.

The PSR's Managing Director, Hannah Nixon, has said that the PSR will, "pursue those duties relentlessly, being evidenced-based and proportionate in the way we do".

So what else can we expect from the PSR over the coming year? For me, there are three major themes: innovation; competition; and enforcement.

The payments landscape is undergoing a period of rapid evolution through technological change. What works currently from a regulatory perspective may not keep pace with new demands which will be placed on the systems in the future. The PSR has to do everything in its power to anticipate and keep pace with technological advances to ensure that it can be a credible and useful regulator.

The PSR has indicated that it is to be an "economic regulator": as a result, competition law principles will be key. Antitrust is certainly an emerging theme in financial services regulation with the FCA (the PSR's parent) obtaining concurrent competition powers.

It will also be interesting to see how the PSR approaches enforcement. The PSR has a number of powerful regulatory and competition tools, including:

- the ability to give directions. This is a very broad power and does not appear to be subject to specific constraints;
- the power to require payment system operators to establish or change rules in relation to the relevant payment system;
- the power to require access to payment systems;
- the power to require a disposal of an interest in a payment system; and
- concurrent competition powers with the CMA.

The PSR can also initiate its own investigations, where it has concerns or there are significant complaints. The PSR is likely to emulate the FCA in relation to enforcement by focusing on strategies of early intervention and credible deterrence to take targeted and effective action against firms.

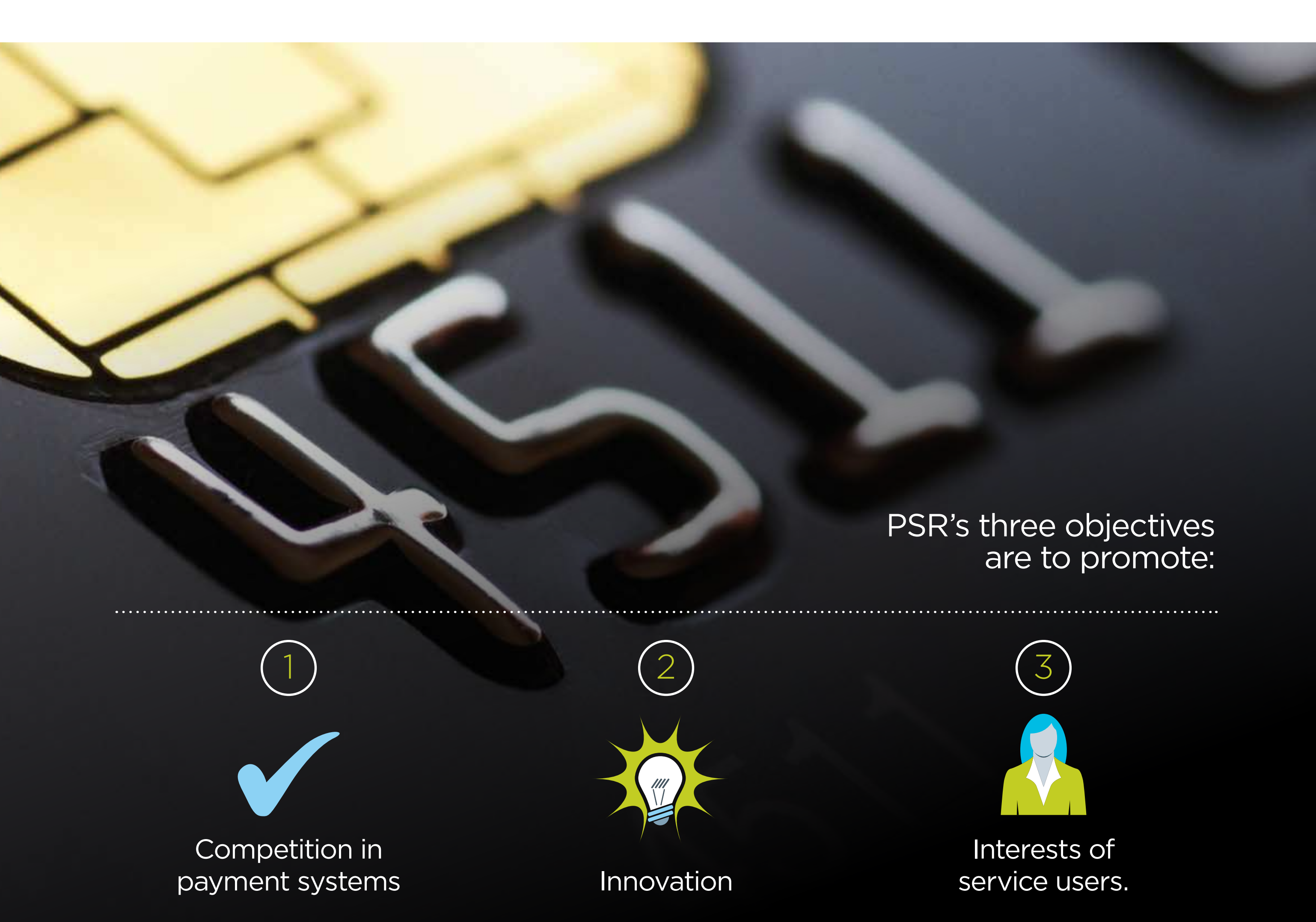
> I think the signs are there that the PSR will hit the ground running and we'll quickly see examples of the PSR flexing its muscles in order to get its name in the press and establish itself as a strong and meaningful regulator. Firms should ensure that they have effective systems and controls in place to meet the demands of this new regulator and ensure that they are not one of its early targets.

Collaboration will also be an important action for the PSR. In order to maximise its potential, the PSR will need to work closely with the industry as well as the FCA, CMA and the Bank of England. In addition, the PSR will need to keep abreast of European developments, especially in the case of the proposed new Payments Services Directive, currently working its way through the European legislative process.

The PSR published a substantial consultation paper in November 2014 setting out the new regulatory framework for payment systems in the UK. The paper covers a wide range of issues including: industry strategy; ownership; governance and control of payment systems; indirect access to interbank systems; interchange fees and regulatory tools. These areas are critical both to the PSR's success as a regulator and, moreover, to the success of the UK payments industry as a whole. The PSR expects to release its final policy statement in March 2015 before it becomes fully operational on 1 April 2015.

All in all, I think the signs are there that the PSR will hit the ground running and we'll quickly see examples of the PSR flexing its muscles in order to get its name in the press and establish itself as a strong and meaningful regulator. Firms should ensure that they have effective systems and controls in place to meet the demands of this new regulator and ensure that they are not one of its early targets.

JACOB GHANTY
Partner, Financial Regulation



TO TWEET OR NOT TO TWEET #FINANCIALPROMOTIONS

Considering the FCA's guidance on the application of financial promotion rules to social media

In August last year, the FCA published a consultation paper on the use of social media in customer communications. The aim was to provide firms with some greatly needed guidance on how the financial promotion rules apply to promotions made via social media networks. Firms were invited to provide their comments with the consultation period ending in November.

As the FCA acknowledges, one of the benefits of social media is that it provides new and smaller businesses with a presence in the market place and the opportunity to reach a far wider audience at a fraction of the cost. The advantage for consumers is the increased competition in the marketplace. The FCA's aim is to encourage competition whilst ensuring that the minimum level of information is provided at the outset of customers' interactions with firms and that any communications are fair, clear and not misleading.

> "One of the benefits of social media is that it provides new and smaller businesses with a presence in the market place and the opportunity to reach a far wider audience at a fraction of the cost."

As part of the draft guidance, the FCA suggests that firms use the handle #ad to ensure that all promotions (even those that are limited by character) can be identified as such. The guidance also provides that firms should consider the appropriateness of character-limited communications for promoting complex products and suggests that these types of communication are instead used to signpost a product a service with a link to more comprehensive information, provided that the signpost is in itself compliant. In practice, ensuring that all social media communications contain the relevant risks and warnings is far more difficult.

The draft guidance that was published, although helpful, does not in my view provide firms with the level of clarity required or with a realistic indication of how firms can practically implement such guidance. Although in an ideal world the same overarching principles would be used for social media communications, in reality the extent to which they are relevant is questionable as the role that social media plays is arguably quite different to more formal communications.

Given the ever increasing use of social media, my view is that the FCA's proposed guidance is definitely a step in the right direction and provides firms with some clarity on the way in which the financial promotion regime will apply to social media. Whilst it is a welcome sign that the regulator is embracing a form of communication that is both widely used and pivotal to the majority of modern day businesses, my main concern is that in the time it takes the FCA to formulate a clear and workable policy the world of social media will have evolved such that the rules are no longer relevant. Despite this, what is clear is that the FCA does not wish firms to shy away from social media communications.

NILEENA PREMCHAND
Associate, Investment Management

A DECADE IN, WHOLESALE INSURANCE BEGINS TO FEEL THE REGULATORY HEAT

It is now 10 years since sales of general insurance products became regulated in the UK, covering wholesale insurance as well as retail insurance products

The regulatory focus in the insurance sector over the past decade has naturally been on retail markets, with payment protection insurance dominating the agenda and proving to be incredibly painful both for authorised firms and regulators. Other aspects of the market, including extended warranties, card theft insurance, gap insurance, other products sold as add-ons to a main purchase - as well as issues relating to outsourcing and sales standards - have all come under scrutiny from the FSA and subsequently the FCA.

In contrast the regulators have, until recently, shown relatively little interest in wholesale insurance markets. In the early stages, the FSA's hand was forced as a result of US investigations in the areas of financial reinsurance and contingent commission arrangements between insurers and brokers. However after a brief flurry of activity the FSA seemed content to allow the market to develop its own solutions.

However the clear view in the market is that the tide has turned and that the PRA and FCA are both becoming increasingly interested in how wholesale markets operate and to ensure that commercial policyholders - in both the SME area and with larger corporate programmes of insurance - are receiving fair treatment. Plainly the PRA will have a significant interest in the largest insurers in the wholesale markets, with particular attention already being paid to capital arrangements, reserving standards, pricing for underwriting profit, accuracy of data systems and standards of governance more generally. Each of these issues will be directly relevant to the risks that the insurer poses to the PRA's core statutory objective.

Perhaps more concerningly is the very noticeable uptick in the FCA's interest in wholesale markets over the last year, with all signs indicating that this interest will only increase in the 12 months ahead.

> "In our experience regulatory responsibilities are given little or no attention in the context of commercial claims handling - typically, a review will be undertaken as to the background circumstances and policy wording, and if the conclusion is reached that there is a legal right to reject the claim then (subject to any commercial relationship issues) the claim will be rejected on these grounds."

It was five years ago in this publication that we highlighted that the area of commercial claims handling standards was one that the regulator had paid little or no attention to during the first five years of general insurance regulation, and we asked whether this was the next big risk area for commercial insurers. We were jumping the gun a little, it seems, but in its 2014/5 Business Plan the FCA announced it would be undertaking a detailed thematic review of commercial claims handling standards.

In our experience regulatory responsibilities are given little or no attention in the context of commercial claims handling - typically, a review will be undertaken as to the background circumstances and policy wording, and if the conclusion is reached that there is a legal right to reject the claim then (subject to any commercial relationship issues) the claim will be rejected on these grounds. However the high level claims handling responsibilities under ICOBS extend to wholesale insurance and impose duties on insurers that potentially go well beyond what the law provides. Unless the insurer's claims handling procedures include an assessment of regulatory standards before a decision is made to reject a claim, then the FCA is likely to treat that as a deficient process and a breach of its rules.

For example, ICOBS requires insurers to handle claims (including commercial claims) "promptly and fairly" and prohibit insurers from "unreasonably rejecting a claim". It is quite possible that it would be lawful to decline a claim and yet it would not in the circumstances be fair or reasonable to do so. Where the insurer's policy wording is ambiguous and was misunderstood by the policyholder when it purchased the coverage, would it be fair to decline a claim that the insurer quite reasonably thought would have been covered?

There are a series of other duties on insurers in ICOBS that apply in the context of handling commercial insurance claims - such as keeping the policyholder properly informed of the progress of its claim and paying out funds promptly once a claim has been agreed - which impose standards not required by the law of insurance. To what extent is a general reservation of rights, followed by wave after wave of document and information requests, really consistent with the insurer's regulatory duties to handle the claim promptly and fairly?

These are areas that will be under close scrutiny by the FCA and if it detects that the wholesale insurance market is not working as well as it should then it will take action - frequently through a combination of supervisory publications and painful enforcement actions against insurers and their relevant approved persons individually, to get their message across to the market.

In addition the FCA has also been undertaking a detailed review of delegated underwriting authority arrangements, in both the Lloyd's market and the companies market, the results of which are due to be published in the first quarter of this year. The FCA is particularly concerned to ensure that product providers (ie insurers and managing agents at Lloyd's) are effectively managing the inherent risks where sales are outsourced to third parties (sometimes through a chain of intermediate parties) over which the insurer has limited visibility and control.

These risks include the dangers of pressure selling and other failures in selling standards, products being sold to those for whom they were not designed and therefore may not provide appropriate coverage, and more generally the quality of service that policyholders receive from the intermediary in relation to policy fulfilment, cancellation, renewal, claims-handling and complaints-handling. As always, the FCA is also interested in the nature and quality of the management information that flows back to the insurer from the intermediary. We are already seeing insurers and managing agents conducting major reviews of their DUA arrangements as a result of issues highlighted by the FCA's thematic review.

Finally, one area that continues to bubble under like an apparently dormant volcano is the issue of broker / insurer commission arrangements and other facilities under which payments are made by insurers to brokers. The FCA's review of broker conflicts in the SME market published in the middle of 2014 appeared not to want to grapple with this aspect. It seems clear that some brokers have now enhanced their own systems to introduce information barriers between those entering into the arrangements with insurers and those responsible for placing business, which plainly goes some way to managing the conflict of interest that exists. However in our view this area remains a high risk area for future regulatory attention and if a market wide investigation is undertaken then the outcomes could well be significant.

In summary, while the last decade has seen limited sporadic interest from the UK regulators in the wholesale insurance market, the signs are that the tide has turned and that the coming year will be a busy one in this area with significant attention from both the PRA and the FCA.

NICK LARKMAN
Associate, Financial Regulation

GETTING THE FUNDAMENTALS RIGHT

Nathan Willmott looks at the PRA's Fundamental Rules and considers their implications for firms

In the constantly changing world of financial regulation that we inhabit - with politicians, regulators and international organisations constantly tinkering with different aspects of the rules - it has become frighteningly easy for fairly significant changes to be introduced without them receiving a great deal of attention.

One such change, introduced last year with a minimum of fanfare, was the PRA's decision to replace the longstanding 11 Principles for Businesses with a new set of binding high level duties for firms, known as the 9 Fundamental Rules.

The required statutory consultation process was followed in the first half of the year, and the PRA Board then approved the finalised Fundamental Rules on 13 June 2014 and published them six days later. However, in stark contrast to the normal approach, the PRA provided no transitional period but rather announced that the Fundamental Rules would come into force with immediate effect.

As a result, the banks, insurers and investment firms who became subject to this new set of mandatory responsibilities were given no transitional period to assess their impact or how best to address the new requirements.

Some of the Fundamental Rules closely mirror the Principles for Businesses, including the duties to conduct a firm's business with integrity (FR1) and with due skill, care and diligence (FR2). Principle 4 (adequate financial resources) becomes FR4, while the Principle 11 duty to deal with regulators in an open and cooperative way and disclose matters appropriately to the PRA at Principle 11 is similarly adopted as FR7.

In other areas, the nature of the duties are familiar but the requirement imposed is more onerous. For example, Principle 3 (organisation and risk management) is split into two separate Fundamental Rules, both of which impose absolute requirements on firms rather than - as under Principle 3 - a duty to act reasonably in all of the circumstances.

As a result, PRA-authorised firms are now subject to an absolute duty to have in place effective risk strategies and risk management systems (FR5) and to organise and control their affairs responsibly and effectively (FR6). Any failure in risk management or the control of their affairs would technically render the firm in breach of the Fundamental Rules, even where it could prove that it had taken all reasonable steps.

In addition, two Fundamental Rules introduced by the PRA do not reflect any of the Principles for Businesses. In both cases, they are accompanied by little guidance or commentary and therefore the steps that firms are required to take in order to adhere to the new duties are wholly unclear.

Fundamental Rule 3 imposes a duty on firms to "act in a prudent manner". Even without this new duty, firms are required to identify, assess and manage the risks that they face as a business in an effective way. Yet Fundamental Rule 3 appears to introduce an overriding duty to act in a more conservative, risk-averse, manner than would otherwise be the case.

> For FR8 to be introduced without any implementation period, or any guidance on the level of detail that is expected or documents that insurers are required to produce, seems to me to be extremely unfair to the regulated community.

While there may be an argument that this is appropriate for the handful of institutions deemed "too big to fail", for other firms the regulatory approach is not intended to achieve a zero failure regime. This additional duty therefore seems out of place and may well have the effect of stifling desirable innovation in the market place.

Finally, a wholly new duty for insurers is introduced under Fundamental Rule 8. This requires each PRA firm to prepare for resolution so that, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services. While banks have had several years to develop their own 'living wills', this is an entirely novel obligation for insurers. For FR8 to be introduced without any implementation period, or any guidance on the level of detail that is expected or documents that insurers are required to produce, seems to me to be extremely unfair to the regulated community.

Furthermore, given the low key manner in which the Fundamental Rules were introduced and the fact that the PRA has not communicated its expectations on resolution plans to the insurance sector, the new duties have simply not featured on the radar for many firms. As a result, as we enter 2015 the impact of FR8 (among others) and the steps that need to be taken to comply with these new requirements should be high on the action list for the Boards of many insurers and managing agents at Lloyd's.

NATHAN WILLMOTT
Partner, Financial Regulation

> The impact of FR8 (among others) and the steps that need to be taken to comply with these new requirements should be high on the action list for the Boards of many insurers and managing agents at Lloyd's.

PRODUCT INTERVENTION POWERS

In recent months, we've seen the FCA begin to flex its muscles through the use of its new product intervention powers; this looks to be an on-going trend

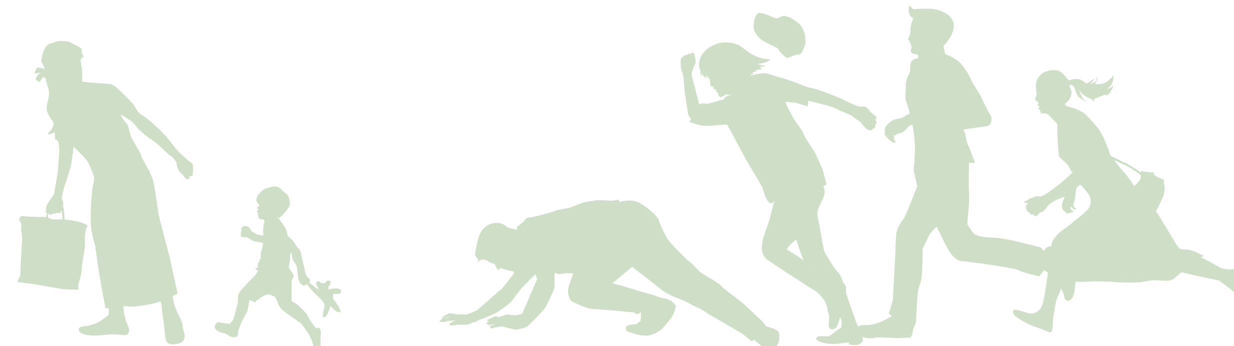
The FCA recently received new powers which enable it to make product intervention rules (which may last for up to 12 months) - without consultation or cost benefit analysis - where it considers it necessary or expedient to do so to advance its consumer protection or competition objectives. The FCA has said that its main consideration will generally be, "whether prompt action is deemed necessary in seeking to reduce or prevent consumer detriment".

In the FCA's first use of these temporary product intervention powers, the FCA restricted firms from distributing contingent convertible securities (known as "co-cos") to the retail market. The FCA's rationale for this was that these instruments are highly complex, with investment risks which are "exceptionally challenging to evaluate and model", making them highly unsuitable for the mass retail market. Although the ban was made without prior consultation, the FCA launched a full consultation in this area at the end of October 2014, which will enable permanent rules to be put in place on the expiry of the ban. The temporary rules enable the FCA to protect consumers whilst allowing the market in co-cos to develop for professional and institutional investors.

I see the use of these temporary product intervention powers as part of a wider initiative from the FCA to use broader risk mitigation powers as part of its policy of early intervention and consumer focus. The FCA is aware of the need to address issues at an early stage on a cost effective basis. Enforcement action is only available once damage has been done and is an expensive use of resources.

The EU also considers product intervention to be vital to the safe operation of financial markets. The Markets in Financial Instruments Regulation (MiFIR) (part of the MiFID II package) will give national regulators wide powers to intervene in product sales from 2016. Whilst this will not be a major change for UK markets, there is a further power which enables the European Securities and Markets Authority (ESMA) (and the European Banking Authority in respect of structured deposits) to take direct action in certain circumstances.

Under MiFIR, ESMA will have the power temporarily to prohibit or restrict the marketing, distribution or sale of certain financial instruments or a type of financial activity. ESMA can take this action in circumstances where the action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or to the stability of the EU financial system; or alternatively where current EU regulatory requirements do not address the threat and member state regulators have not themselves sufficiently addressed the threat. Any ESMA imposed prohibition or restriction must be reviewed (and if appropriate, renewed) at least every three months, otherwise it will expire.



As a consequence, ESMA will be able to take direct action in member state markets, overriding any action (or inaction) by the local regulator. This could place firms in a very difficult position if they are receiving conflicting directions from both national and European regulators. It remains to be seen how this Europe-wide power will work on a practical level, but this is an area which may well be open to challenge.

> Perhaps the most important message for firms is that they should focus carefully on their product design processes to ensure that their products are appropriate for the target market.

In my view, perhaps the most important message for firms is that they should focus carefully on their product design processes to ensure that their products are appropriate for the target market with minimal (or, alternatively, very clearly understood) risk of customer detriment. The FCA will continue to flex its muscles through the use of product intervention powers over the coming years, and together with the new ESMA powers, product design is an area firms will certainly need to get right to avoid regulatory action.

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