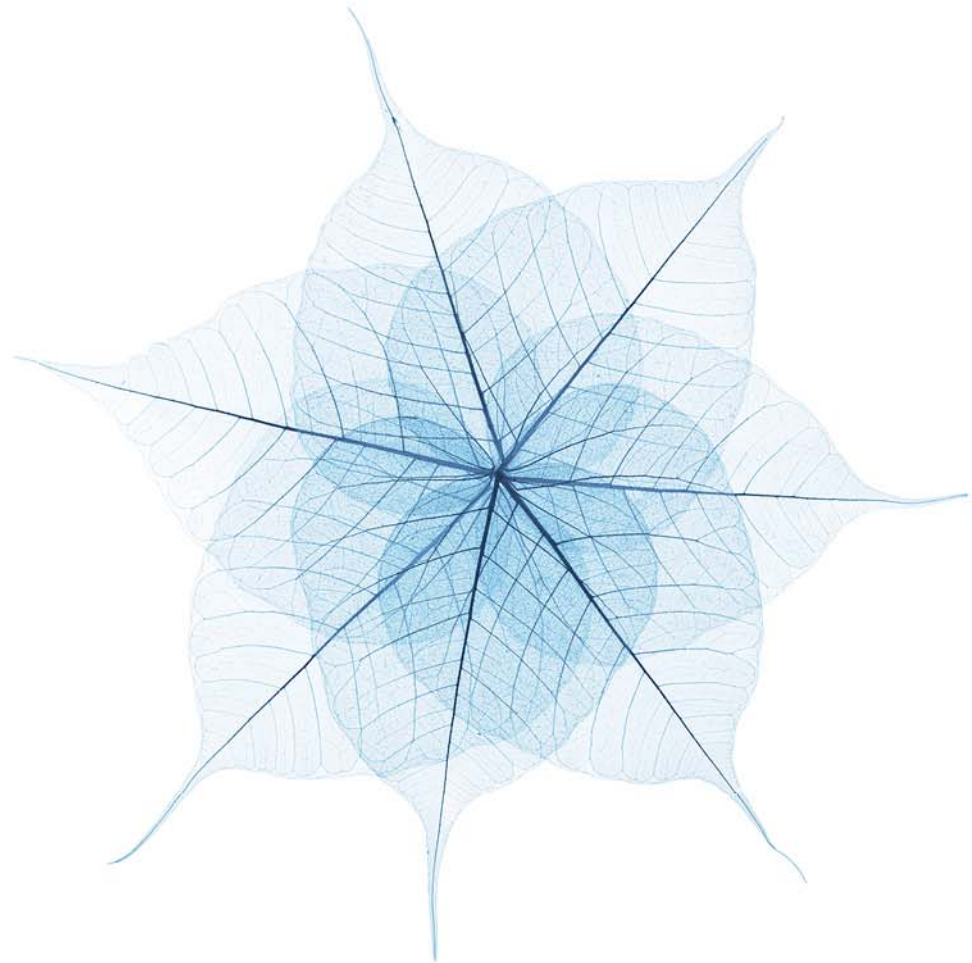


Your World First



Regulatory update

Simon Morris
March 2017



Looking at ...

1. Individual regulation
2. Recent developments
3. Implementing the B word

The new agenda for individual regulation

The Bank of England and Financial Services Act 2016 extends the SMCR to all sectors of the financial services industry. It also allows us to apply all elements of the regime to insurers. We intend that our extended regime will be clear, simple and proportionate. During Q2 of this year we will be consulting widely with industry, firms and consumers on our proposals. We **expect implementation to begin from 2018.**

FCA 7 March 2016

How will it work in practice?

Senior managers

Prior regulatory approval

Statement of responsibility

⇒ Responsibilities Map

Subject senior manager rules

Certified staff

Firm certifies as fit and proper

Subject first tier rules only

Most remaining staff

Subject first tier rules only

Senior managers

The job description ...

- Takes or participates in decisions
- Part of the firm's regulated activities
- With risk of serious consequences

There are three ways of becoming a senior manager ...

1. Your job description, such as

Executive

SMF1 Chief Executive function

SMF2 Chief Finance function

Non-executive

SMF9 Chairman function

SMF10 Chair of the Risk Committee function

2. You “must have” responsibility such as

- Recovery & resolution planning
- CASS compliance
- Financial crime

3. You hold a key function, such as

- Design and manufacturing of products
- Marketing materials
- Customer service
- Customer complaints

Statement of responsibility ...

Individual statement of responsibilities

- Prepare & lodge when seeking approval & significant changes
- Important opportunity to clarify & codify responsibilities
- Standard form with limited free text

It must be

- Be practical and usable
- Consistent with responsibilities map
- Complete and only contain FCA-relevant material
- Show how responsibilities fit with governance & management

Responsibilities map

A computer folder with files

- Single, comprehensive up-to-date document to ensure collective allocation of responsibilities complete
- Describing management and governance arrangements
- Showing no gaps and how fit together
- Not limited to UK or to regulated activities

Containing

- Names & responsibilities (reconciling with SoR)
- How responsibilities allocated
- Reporting lines
- Management & governance arrangements
- Including group responsibilities

First tier – rules for everybody

Individual Conduct Rules

- **Rule 1:** You must act with integrity.
 - Manage risk, exercise sound judgement, observe rules as well as honesty
- **Rule 2:** You must act with due skill, care and diligence.
 - Understand the business, the regulations and act compliantly & competently
- **Rule 3:** You must be open and cooperative with the regulators.

FCA only

- **Rule 4:** You must pay due regard to the interests of customers and treat them fairly.
 - The TCF requirement made a personal promise – do the procedures enable this?
- **Rule 5:** You must observe proper standards of market conduct.
 - All markets, not just listed securities

Second tier – Senior Manager Conduct Rules

- **SM1:** You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
- **SM2:** You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system.
- **SM3:** You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
- **SM4:** You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

The consequence ... individual discipline

Currently –

1. You **failed to comply** with rules of conduct; or
2. You have been **knowingly concerned in an authorised person's contravention** of a relevant requirement

And now – **a statutory duty** on senior managers to **take reasonable steps** to prevent regulatory breaches in their areas of responsibility.

3. The firm contravened a rule
 - a) Which **fell within the responsibility of a senior manager/NED** in his senior management function
 - b) And he **did not take reasonable steps** to avoid the contravention (this is, as for 1 and 2, for the regulator to prove)

Has behaviour changed?

- Certainty of allocation
- Clarity of reporting lines
- Caution in decision-taking
- Recognition of responsibility

Certified staff will be ...

- Employees who perform a specified significant harm function
 - = provide services whom the firm supervises, directs & controls
- Must be certified as fit and proper
 - To perform every aspect of stated functions, listed in broad terms
 - For 12 months, then reassessed; reassess if function changes
 - Unless up to four week's cover where not require qualifications
- Fit & proper means can perform efficiently & compliantly
 - Integrity
 - Knowledge, competence & experience
 - Qualifications & training

And the significant harm functions (for a bank) are

...

The employee is involved in the bank's regulated activities, is not an SMF and ...

PRA is based anywhere & falls within MRT Regulation; or

FCA is based in UK/deals with customers and involves a risk of significant harm to it/customers as

- **Significant manager** – with significant responsibility for a significant business unit (considering its risk profile, use of bank capital, contribution to P&L, staffing and customers) such as head of retail banking, lending, loan recovery or proprietary trading, or a member of a committee taking decisions about that unit
- **Managers of certification employees** – both direct and indirect
- **Functions requiring qualifications** – TC App 1 – principally retail investment and mortgage advisers
- **CASS oversight**
- **Benchmark submission and administration**
- **Proprietary trader**
- **Client dealing & algorithmic trading (still subject to consultation)**
- **Material risk taker, including**
 - Head of Risk, Internal Audit, Compliance
 - And divisional reports
 - Head of Risk in 2% of capital business unit
 - And divisional reports
 - Head of material business unit
 - And divisional reports
 - Head of legal, finance, HR, IT
 - Authority over product approval
 - All of their managers
 - Remuneration criteria - €500k/top 0.3%/>others

All other staff

All other staff – at banks – apart from twenty designated categories such as cooks, cleaners and receptionists will be subject to 1st tier conduct rules

Staff = employee and providing services to bank subject to its supervision, direction & control

You will need to ...

1. **Advise** those subject to COCON of the rules
2. **Contractually oblige** an SMF to observe COCON
3. **Report** breaches
 - a) Knowledge or suspicion of non compliance
 - b) Disciplinary action for breach – warn, suspend, dismiss, dock pay
4. **Train** – take all reasonable steps to ensure understanding, including by training
 - a) Broad understanding generally
 - b) Deeper understanding specifically

And the tasks to start planning for ...

1. Categorising staff & allocating responsibilities
2. Preparing the Statements
3. Drawing the map
4. Codifying fit and proper
5. Grandfathering or applying
6. Training all staff
7. Papering the HR aspects
 - a) Contracts
 - b) Staff handbook
 - c) Handover certificates
 - d) Referencing
 - e) Breach reporting

Some current issues

Re-emphasis of regulatory focus

FCA & PRA should have regard to ...

- More competition, especially retail banking; minimising entry barriers and ensuring diversity of business models
- Financial services making positive contribution to sustainable economic growth as a productive sector & facilitating finance
- UK remains attractive domicile and the City the leading international financial centre
- Innovation to engage with consumers & raise capital
- Better consumer outcomes

HMT Recommendations 8 March 2017

Regulators increasingly harnessing economics

My perspective is that we must discuss how **economics and other disciplines can help regulation** because the challenges regulators face are large and chronic.

If regulators are to make markets work better, we need to **understand whatever materially drives the equilibria we observe**. In particular the decisions that firms, consumers and, of course, regulators take.

Financial consumers are especially vulnerable as many financial products are **credence or experience services** ...

Sophisticated suppliers can observe consumers' heuristics and can **design responses to undermine these heuristics**. All suppliers can observe consumers' decisions under different conditions. Then **change marketing strategies** to sell more of what they want to sell at prices nearer the ones they want to charge.

FCA Peter Andrews: Beyond economics (14 June 2016, published January 2017)

And looking at VfM

The value measures included in the pilot are:

- **Claims frequencies** - How often consumers are claiming on their insurance policies – calculated as the number of claims registered, divided by the average number of policies in force
- **Claims acceptance rates** - How likely claims are to be accepted – calculated as the number of claims registered less the number of claims rejected, divided by the number of claims that have been registered.
- **Average claims pay-out** - Average claims pay-out which could include internal costs and relevant external costs as well as pay-outs to policy beneficiaries. For example, costs could include internal or external claim investigation costs or payments to third parties to repair a customer's damaged wall.

FCA: General Insurance value measures pilot (25 January 2017)

PRA/FCA Enforcement Review

- More information in MoA
- More ongoing engagement during the process
- Accelerating the provision of information in settlement
- Stage 1 (@70%) remains at 28 days with increased senior visibility
- Abolition of stage 2 and 3 discounts to penalty in settlement
- Introduction of partly contested cases

FCA PS17/1/PRA2/17: Implementation of the Enforcement Review and the Green Report (February 2017)

Change to regulated activity of advising

From 3 January 2018 Art 53 RAO alters to exempt most regulated firms from the need to hold a permission to advise on investments under unless providing a personal recommendation.

Firm type	Effect of changes on regulatory perimeter
Regulated firm with 'advising on investments' and/or 'agreeing to advise on investments' permission(s) and another permission.	These firms can provide advice on financial products and services without the advising permission(s). However, they will need to keep the advising permission(s) if they provide personal recommendations.
Regulated firm without the 'advising on investments' or 'agreeing to advise on investments' permission(s) but with another permission.	These firms can provide advice on financial products and services without the advising permission. However, they will still need to seek the advising permission(s) if they want to provide personal recommendations.
Regulated firm with 'advising on investments' and/or 'agreeing to advise on investments' permission but without another permission.	No change – the scope of regulated advice for which permission is required remains the same.
Unregulated firms and individuals.	No change – these firms and individuals will not be able to provide any form of regulated advice.

And admonitions for asset managers

Reviewing for best execution

Who would the FCA hold responsible for Bex?

Do we have a comprehensive strategy for overseeing BEx?

Have we tested that portfolios are not overpaying for BEx? Have we compensated if needed?

Does our order execution policy accurately reflect our business model?

What has monitoring shown?

Is the gift & entertainment policy compliant?

Have staff been adequately trained on BEx?

FCA: Investment managers still failing to ensure effective oversight of best execution (3 March 2017)

Dealing commission

FCA preferred approach ...

- Research – bought with own funds
- Research budget – controlled
- Systems & controls – present
- Records – maintained
- Corporate access – conflict risk managed
- Overseas & outsourced – included in process

FCA: Firms continue to fail to meet our expectations on their use of dealing commission (3 March 2017)

Prudential Regulation Committee

- On 1 March, the PRA Board will be replaced by the Prudential Regulation Committee (PRC), and the PRA will be brought within the single legal entity of the Bank of England. These changes are required by the Bank of England and Financial Services Act 2016 (the Act).
- From the above date the PRA's most important supervisory and policy decisions will be made by the PRC. There are no changes to the PRA's objectives or functions.
- The PRC is now on the same legal footing as the Monetary Policy Committee and the Financial Policy Committee.

PRA: Prudential Regulation Committee replaces PRA Board (28 February 2017)

Interchange of taxation information

HMRC => FCA

Section 18 Commissioners for Revenue and Customs Act (CRCA) sets out the specific circumstances in which HMRC may disclose information. The legal gateways are:

- Section 350 Financial Services and Markets Act 2000
- Section 19, Anti-Terrorism, Crime and Security Act 2001
- Regulation 49A, Money Laundering Regulations 2007

FCA => HMRC

The legal gateway(s) permitting disclosure of information from the FCA to HMRC are:

- The Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001
- Regulation 119, Payment Services Regulations 2009

With additional powers for fraud purposes

FCA/HMRC: MoU (November 2016, published January 2017)

Implementing the referendum result

European Union (Notification of Withdrawal) Act 2017

Power to notify withdrawal from the EU

- (1) The Prime Minister may notify, under Article 50(2) of the Treaty on European Union, the United Kingdom's intention to withdraw from the EU.
- (2) This section has effect despite any provision made by or under the European Communities Act 1972 or any other enactment.

With the need for Parliamentary scrutiny

The process of **converting the body of EU law**, as described by the Government, will consist of two distinct phases.

1. The **initial mechanical preservation** of EU law by converting it into UK law with such amendments as are necessary to make it work sensibly in a UK context – Great Repeal Bill;
2. A longer-term process in which Parliament and the Government determine the extent to which (what was) **EU law will remain part** of UK law – discretionary, through Parliamentary process. The Government will introduce primary legislation to make substantive changes to certain areas currently covered by EU law, including **immigration and customs law**, alongside the process of domesticating the body of EU law through the ‘Great Repeal Bill’. Law in these areas will be contingent upon the outcome of negotiations with the EU, so this primary legislation may also contain wide-ranging delegated legislation to allow Government to adapt their contents in light of the final withdrawal agreement.

Scrutiny of secondary legislation

1. The Minister **sign a declaration** in the Explanatory Memorandum to each statutory instrument amending the body of EU law stating whether the instrument (a) does no more than necessary to ensure that the relevant aspect of EU law will continue to make sense in the UK following the UK's exit from the EU, or (b) to implement the outcome of negotiations with the EU.
2. The **Explanatory Memorandum** to each statutory instrument sets out clearly what the EU law in question currently does (before Brexit); what effect the amendments made by the statutory instrument will have on the law (as it will apply after Brexit) or what changes were made in the process of conversion; and why those amendments or changes were necessary.
3. The Government makes a recommendation for each statutory instrument as to the **appropriate level of parliamentary scrutiny** that it should undergo. We would expect that a statutory instrument which amends EU law in a manner that determines matters of significant policy interest or principle should undergo a strengthened scrutiny procedure.

House of Lords Select Cttee on the Constitution 9th Report 7 March 2017

HMG policy for financial services

The UK's financial services sector is a hub for money, trading and investment from all over the world and is **one of only two global, full service financial centres** – and the only one in Europe. In 2016 the Global Financial Centres Index once again ranked London as the number one financial centre.

Citizens, businesses and public sector bodies across the continent **rely on the City to access the services** that they need. Over 75 per cent of the EU27's capital market business is conducted through the UK. The UK industry manages £1.2 trillion of pension and other assets on behalf of European clients. The UK is also responsible for 37 per cent of all European Initial Public Offerings, while the UK receives more than one-third of all venture capital invested in the EU. EU27 firms also have an interest in continuing to serve UK customers.

There are ... financial services passports [and] provisions that **allow firms from ‘third countries’** to provide services across the EU, provided that their relevant domestic regulations have been deemed equivalent to those of the EU. In our new strategic partnership agreement we will be **aiming for the freest possible trade in financial services** between the UK and EU Member States.

In highly integrated sectors such as financial services there will be a **legitimate interest in mutual cooperation arrangements** that recognise the interconnectedness of markets, as so clearly demonstrated by the financial crisis ... As the UK leaves the EU, we will seek to establish **strong cooperative oversight arrangements** with the EU and will continue to support and implement international standards to continue to safely serve the UK, European and global economy.

Extracts from HMG: The United Kingdom’s exit from and new partnership with the European Union (February 2017)

Third-country equivalence as a substitute for the financial passport

Recommendation: The existing third-country equivalence regimes in certain pieces of EU legislation are an **inadequate substitute for the financial passport**. They do not cover the full range of financial services activities, excluding in particular deposit-taking and lending, retail asset management and payment services. As they are agreed at a point in time, and are static, they may also be vulnerable should regulation change to respond to the development of the financial system. The process of updating them as EU-wide regulation changes would be laborious and time-consuming.

Response: The **sub-Committee's assessment is noted**. This concurs with other published analysis and the drawbacks of existing equivalence regimes are well understood. The government is committed to pursuing the freest possible market access within our future relationship with the EU.

Government response to the House of Lords European Union Committee Report, 'Brexit: financial services' 21 March 2017

The need for a transitional period

Recommendation: We are concerned that, in the absence of clarity over the future relationship, firms may pre-empt uncertainty by relocating or restructuring, for instance by establishing subsidiaries or transferring staff, even though such changes may ultimately prove to be unnecessary. This would not be in the interests of the industry or the UK.

Response: We agree that financial services is an important, complex topic that will play a very important role in the upcoming negotiations. The government **notes the risk of relocating and restructuring**, and will seek to address it by providing as much certainty as possible through the negotiation process. It is clear that it will **seek to avoid a disruptive cliff-edge** as the UK exits the EU and will aim to agree a phased process of implementation which will provide time for businesses and regulators to adapt to the terms of the new relationship.

Government response to the House of Lords European Union Committee Report, 'Brexit: financial services' 21 March 2017

The exit plan

- We understand and respect your position that the **four freedoms of the single market are indivisible** and there can be no "cherry picking".
- We also understand ... that we will **lose influence over the rules** that affect the European economy. UK companies will, as they trade within the EU, have to align with rules agreed by institutions of which we are no longer a part.
- We should work towards **securing a comprehensive agreement** ... a deep and special partnership between the UK and the EU ...
- ... we believe it is necessary to **agree the terms of our future partnership** alongside those of our withdrawal from the EU
- We should work together to **minimise disruption and give as much certainty** as possible. Investors, businesses and citizens ... want to be able to plan.

PM's letter 29 March 2017

Delivery

- We propose a **bold and ambitious Free Trade Agreement** ... of greater scope and ambition than any such agreement before it so that it covers sectors crucial to our linked economies such as financial services and network industries.
- This will require **detailed technical talks**, but as the UK is an existing EU member state, both sides have regulatory frameworks and standards that already match.
- We should therefore prioritise how we **manage the evolution of our regulatory frameworks** to maintain a fair and open trading environment, and how we resolve disputes ...
- ... my officials will **put forward detailed proposals** for deep, broad and dynamic cooperation.

A rough balance sheet for negotiations

United Kingdom

- Contributes c12% EU budget
 - One of few net contributors
- EU's only global financial centre
 - Important provider EU financial services
- EU must agree free movement services
 - On what terms?
 - Goods?
 - But never people?

EU27

- Can't divide the four freedoms
- City will still be available to EU27 firms
 - May spur the also-rans
- UK
 - Outside €
 - Opponent of ECU project
 - Anglo-Saxon liberalism
- Softening sets a precedent

And also ...

... many are now **hoping for an equivalence decision to fill the gap left by passporting rights**. If the European Commission deems the **regulatory and supervisory regime in the UK** to be equivalent to that in the EU, market access would be partly retained. However, I am rather sceptical about whether equivalence decisions – may they be likely or not – offer a sound footing for long-term location decisions of banks. **Equivalence is truly different from single market access.**

There are three major drawbacks to equivalence decisions. **First**, they only cover the wholesale business of banks. **Second** ... an equivalence decision would have to be taken quite soon to actually have a bearing on the location decisions of banks. **Third**, equivalence decisions are reversible.

Could a **free trade agreement** be the solution? ... negotiating comprehensive free trade agreements is an arduous and time-consuming task, financial services are an especially tricky area. So far, the EU has never fully integrated finance in its free trade agreements with third countries

Therefore ...

As a consequence, many banks are **now considering moving some of their activities to the EU**. First, let me say that I expect London to remain an eminent global financial centre ...

The question that is causing some excitement is: Where will banks go? As a supervisor, my main concern is that banks are supervised according to standards that are both high and consistent. This is **best ensured within the SSM area**. This

Of course, we also **emphasise the requirements for establishing a licensed entity there**. For example, this means that we will not accept any empty shells or “letterbox companies” where the business effectively continues to be done out of London. For critical functions such as **management, controlling and compliance, qualified personnel** need to be present at the non- UK EU subsidiary at all times. And I urge banks not to spend their time inventing strategies to circumvent these requirements. This includes seemingly creative solutions such as “fly-and-drive” banking or “dual hatting”, where transactions are booked on the EU subsidiary but in fact executed in London.

And also ...

My main message here is that we must avoid a **regulatory race to the bottom** at all costs ... in January, Chancellor of the Exchequer Philip Hammond made it clear that the UK would "do whatever [it has] to do" to regain competitiveness.

Regulation and supervision in the UK have been both highly professional and stability-oriented in the past. I strongly hope that supervisors here will be able to keep up this good work and **turn a blind eye to demands for deregulation and lax supervision** ...

To be clear, my call to refrain from using regulation or supervision for the sake of increasing one's competitiveness is **equally addressed to the EU** ...

BIS: Speech by Andreas Dombret: The possible impact of Brexit on the financial landscape (24 February 2017)

The need for a “Plan B”

... there is a **real prospect** that negotiations will fail. The Government should require each Department to produce a 'no deal' plan identifying the likely consequences and making proposals, including guidance to individuals and businesses, to mitigate potential risks. Anything less would be a dereliction of duty.

- Unprecedented
- Very short timetable
- Very political
- 17 EU elections
- Significant budgetary liabilities – UK provides 12% EU budget

Implications of 'no deal' include:

- Ongoing disputes over the exit 'bill' – uncushioned 3rd country status
- Uncertainty and confusion for UK citizens in EU and EU citizens in UK
- Trading on World Trade Organisation (WTO) terms
- A 'regulatory gap' and legal uncertainty in areas not covered by the "Great Repeal Bill"
- Uncertainty over UK participation in the EU's common foreign and security policy
- A customs border between Northern Ireland and the Republic of Ireland

**Foreign Affairs Cttee Report Article 50 negotiations: Implications of 'no deal' 7
March 2017**

Brexit road map – London Market Group

Regulatory equivalence under Solvency II: While this would not give market access rights to the EU for UK insurers and reinsurers, it is important in agreeing a trade deal with the EU that our prudential regulatory regimes remain comparable.

A right for UK insurers and reinsurers to have unimpeded access to the EU market: A new trade agreement with the EU, which gives a specific right for UK-based insurers and reinsurers to accept business introduced to them by brokers from the EU and a reciprocal right for EU insurers and reinsurers to do business in the London Insurance Market, unimpeded by additional capital requirements and allowing home state prudential supervision.

Early agreement of an implementation period with market access rights: It is important to agree at the start of the negotiations an implementation period to move to the new agreement, during which the industry's current market access rights would be retained. Uncertainty over whether insurance policies will be enforceable is already affecting the decisions of the London Insurance Market's clients.

A wake-up call

Regulation is a **key factor for top level boards of directors** in deciding where to place capital investment. With significant M&A activity within the sector over recent years, these decisions are often now made outside the UK. It is vital that regulation remains proportionate and does not put London at a disadvantage. This represents the best way to prevent significant capital flows from leaving London.

Many competitor jurisdictions are **actively courting financial services** in the UK and offering incentives to move their business abroad. For example targeted companies have been offered the opportunity to file in English, have their applications for licences and branches fast tracked as well as providing a more personalised service than that offered by the PRA.

After Brexit, regulation will be an even bigger factor for foreign investors in **deciding where to place capital investment** and it is vital that our regulatory regime helps the London Insurance Market to compete.

Our competitors in Singapore, Qatar, Dubai and Bermuda have regulators with **statutory duties to actively support the promotion** of their local insurance markets. The FCA and PRA do not have such objectives and are not required to have regard to the impact of their actions on the competitiveness of the financial services sector.