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Regulatory Roundup
24 March 2015
Issue 63

In Brief:

Allocation, Allocation, Allocation: Aviva fined £17.6m due to Systems and Controls Failings

EMSA Peer Review: ESMA publishes review on the supervision and enforcement of MiFID requirements relating to best execution

Financial Promotions: Social Media: Firms' use of social media under the FCA microscope following publication of Finalised Guidance

AIFMs: Changes to Handbook: The FCA publishes its Quarterly Consultation Paper CP15/8 this month

FATCA Reminder: First returns must be submitted to HMRC by 31 May 2015

Compliance Officer Prohibition: Publication of three Final Notices reminds us that the FCA may pursue individuals

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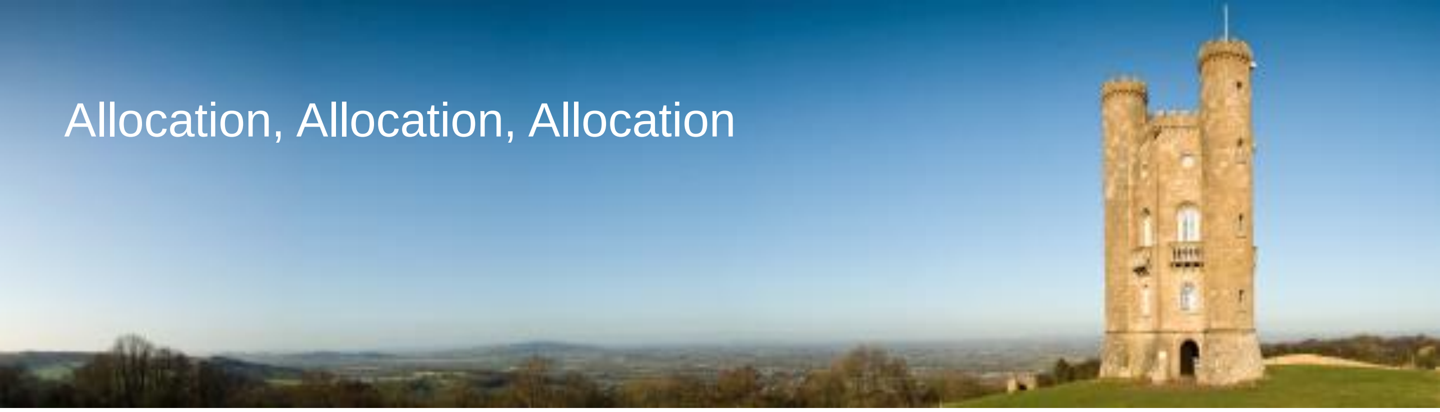

Allocation, Allocation, Allocation

Useful links:

[Final Notice]

Aviva Investors Global Services Ltd has been fined £17,607,000 for what the Final Notice describes as **systems and controls failings** which led to its failure to manage **conflicts of interest** fairly. If it had not been for a combination of the traditional 30% 'Stage 1' discount **and** mitigating factors (the firm's prompt compensation exercise and open and cooperative manner) the fine would have been closer to £34m.

Although the Final Notice advises breaches of Principle 3 (Management and Control) and Principle 8 (Conflicts of Interest), arguably at the heart of the problem was the firm's failure to ensure compliance with COBS 11.3 ('Client order handling') and COBS 11.5 ('Record keeping: client orders and transactions').

COBS 11.3.2 requires client orders to be **promptly** recorded and **allocated** whilst the requirements of COBS 11.5.2 include the need to record the name or designation of the client **immediately** after **executing** a client order.

As is sometimes the case with asset management firms, Aviva's managers were responsible for the management of several portfolios which paid **differing** levels of **performance fees** – the Final Notice advises the fees could range from 20% (a Hedge Fund) to nil (certain traditional Long-Only Funds). Given that at least half of these performance fees were paid to the traders there was an obvious conflict of interest where these funds were trading in the same instruments. It is interesting to note that during the nearly eight year period in question, **£27.4m** was paid to certain traders as a result of Hedge Fund performance. Furthermore Aviva found evidence of delayed booking and improper allocation of trades by two former traders which led to the firm paying **compensation** of **£132m** to eight funds that may have been adversely impacted as a result of poor controls.

Although Aviva did recognise the potential conflict to the extent that it was duly noted in its Conflict Log, it **failed** to **manage** the inherent conflict; whilst SYSC 10.1.6 concerns the need to record conflicts, the effect of SYSC 10.1.7 is to require firms to manage such conflicts to prevent them from giving rise to a risk of damage to the interests of a firm's clients.

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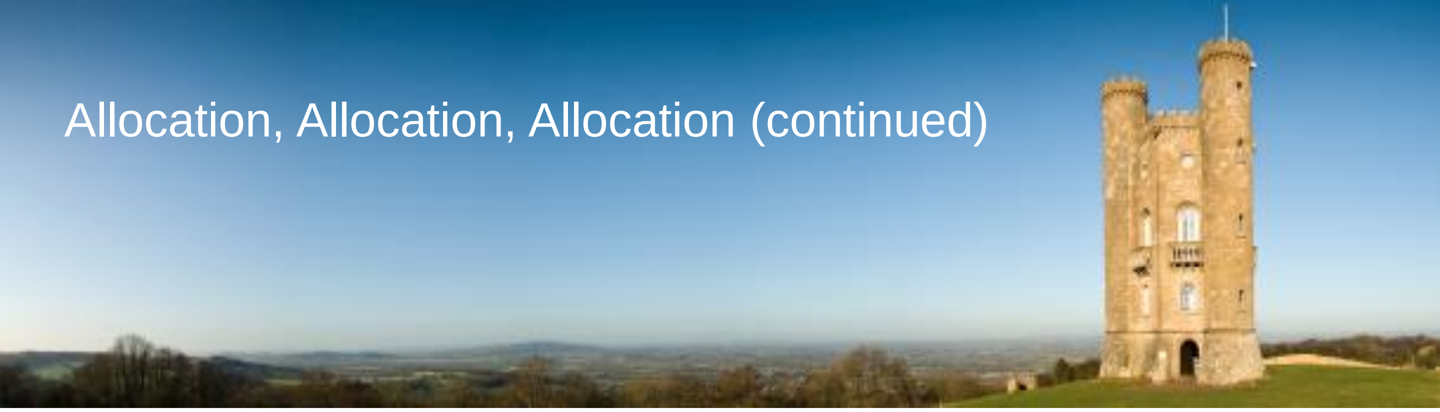

Allocation, Allocation, Allocation (continued)

Compliance with COBS 11.3.2 and 11.5.2, particularly with reference to the 'promptly' and 'immediately' aspects, is an effective way of eliminating the danger of 'cherry picking' in which a trader could wait until the end of the day before allocating deals to ensure that those securities which had benefitted from favourable intraday price movements end up in the funds paying the highest performance fees. Aviva did have policies in place for the prompt allocation of trades but did not have the business controls in place (the so called **'first line of defence**') to ensure compliance e.g. the process, as opposed to the policies, did not require traders to record the intended allocation prior to booking the trade and lack of readily available data meant that delays in the booking and allocation of trades intraday could go undetected.

Aviva's monitoring and oversight ('**second line of defence**') came in for criticism with **inadequate compliance monitoring** which was no doubt exacerbated by Compliance being **under-resourced** and lacking the 'credibility and respect' to provide robust challenge. The firm's Internal Audit function ('**third line of defence**' – which for those firms that do not have such a function can also be read to include **independent assurance**) also demonstrated weaknesses that meant identified issues were not addressed in a **timely** or **effective manner**.

Although perhaps of less relevance to smaller asset managers with the one client, we would recommend that those firms subject to COBS 11 review the findings in the Final Notice and compare them to their own practices. In particular it is worth bearing in mind that whilst one can have 'a policy' in place, it is important not to overlook the importance of the 'three lines of defence' i.e. to have the business controls in place and adequate compliance monitoring. It is appreciated that many firms may not have the luxury of an Internal Audit function, although Complyport clients will have the benefit of our independent review during our on-site visits.

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EMSA Peer Review

Useful links:

[ESMA Peer Review (2015/494)]

[Complyport Alert]

[TR14/13]

As may be recalled, last July the FCA released the results of a thematic review (TR14/13) on ‘Best execution and payment for order flow’; the conclusion was that most firms were **not** doing enough in this area – see Complyport Alert. The best execution rules and guidance are, of course, in COBS 11.2.

ESMA has now stepped into the frame with the publication of its **peer review** (2015/494) on how national competent authorities (NCAs) supervise and enforce the MiFID requirements relating to best execution.

The review was based upon information provided by **29 NCAs** and **on-site** visits between June and August last year to the NCAs of France, Liechtenstein, Luxembourg, Malta, Poland and Spain. Although the UK was not subject to a visit, chapter 3 informs us that **most of the firms** subject to best execution are located in the **UK** (4,143 firms), followed by Germany accounting for 2,485 firms and France (956).

Findings in the report include:

- oversight of best execution is usually a component of the supervision of general conduct of business issues and is often limited to simply verifying that an execution policy exists
- best execution is often only viewed in terms of price without regard to the other execution factors (cost, speed, likelihood of execution and settlement and order size)
- execution venues tended to be concentrated in the main domestic market with little in the way of alternative venues
- monitoring of best execution of non-equity and less liquid markets is largely absent
- the low rate of investor complaints relating to best execution may well be down to a lack of understanding.

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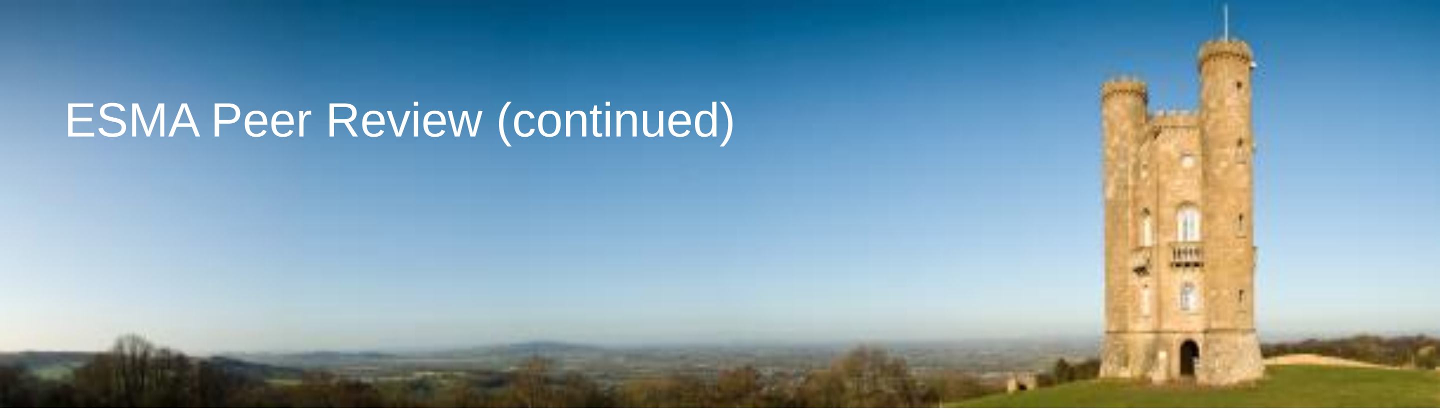
ESMA Peer Review (continued)



Future work by NCAs and ESMA identified include:

- providing guidance for the national implementation of MiFID rules to ensure common understanding
- assessing the adequacy of NCAs' resources devoted to the supervision of best execution
- providing guidance to help NCAs develop assessment criteria to be used when firms use only one execution venue
- developing specific consumer education programmes.

Although ESMA's role is not really the 'supervisor's supervisor', given the FCA's previously voiced **concerns** on best execution, it wouldn't take much stretch of the imagination to believe that the FCA will fully take on board the comments within the peer review and continue its focus on this area. We would recommend that firms subject to COBS 11.2, and that have not yet reviewed their existing processes and procedures following the publication of TR14/13, should ensure that such a review is suitably prioritised. It would, of course, be prudent for the review to take into account the findings in both TR14/13 and the ESMA peer review.

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Financial Promotions: Social Media

Useful links:

[**FG15/4**]

[**Regulatory Roundup 45**]

The use by firms of '**social media**' e.g. Facebook, Twitter etc. has come under the FCA microscope with the publication of Finalised Guidance FG15/4 ("**Social media and customer communications**").

From the outset the Guidance makes it clear that whilst the FCA does not want to prevent their use – and indeed acknowledges that they can be powerful channels of communication – it does want firms to remember that although they may be in a digital format they can be 'customer communications' and, potentially, 'financial promotions'. The Guidance emphasises that "a promotion is a promotion". This is not the first time that the Regulator has raised the issue of 'digital media' e.g. a speech in 2012 (see Regulatory Roundup 45) reminded us that the financial promotion rules are **media-neutral** i.e. the rules focus on the **content** regardless of the medium used to communicate that content.

For those firms considering using social media the Guidance provides several **illustrated examples** of compliant and non-compliant tweets and banners and suggests the use of image insertion to overcome any problems that might be associated with character limitation. It also provides guidance when such communications are forwarded, for instance a tweet intended for another authorised person which is retweeted to a retail customer.

However, despite its title, firms that have no immediate plans to use such media will find the Guidance a useful addition to their reference material. By way of example, the discussion on the use of (compliant) links to websites within a tweet (para 1.13) can be equally relevant to a firm's website which contains links to other pages of the site. Elsewhere the Guidance provides commentary on the meaning of, and the relevance of, "**in the course of business**"; the benefits of **image advertising** (e.g. it is exempt from most of COBS 4) and the importance of balance in terms of risk and reward.

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AIFMs: Changes to Handbook

Useful links:

[CP15/8]

[FATF Public Statement (February 2015)]

The FCA’s Quarterly Consultation Paper CP15/8 published this month will be of particular interest to **AIFMs** (and AIF depositaries) in that it contains various proposed rule changes that will be relevant to them. In isolation none of them are major, but it would be as well to be aware of them. Some may have an element of déjà vu about them e.g. comments re FATF, value of AIFs, passporting etc.

Below is a summary of the more relevant changes but affected firms should make themselves familiar with revised rules and guidance (see **Appendix 4** of CP15/8).

- The regulated activity of ‘managing an AIF’ includes, of course, all other regulated activities e.g. ‘arranging’, ‘managing’ etc. needed to be “the AIFM” and the AIFM does not need to apply to the FCA to have these activities added to its permission. As such, an AIFM’s Part 4A permission may only contain ‘managing an unauthorised/authorised AIF’. Because of consumer protection concerns FUND 1.4 will require **a UK AIFM to notify the FCA in writing two months in advance (the CP includes the notification form) of any regulated activities performed in connection with the management of an AIF**. Fortunately the rule will **not apply** if those activities are the usual suspects associated with managing an AIF e.g. ‘managing investments’ or ‘arranging’ – see FUND 1.4.8 (2) for the full list. For the avoidance of doubt, the proposed rule on notification will not apply to ‘**insurance mediation**’ either (as long as it relates to the management of an AIF) – which in any event, for a firm undertaking that activity, is not included in ‘managing an AIF’ and instead must be included on the said firm’s Part 4A permission.

- When calculating the **value** of AIFs for the purposes of covering professional liability risks (“ **PII**” - see (IPRU(INV) 11.3.11) one must also **include** any AIFs that the AIFM may be managing **under delegation** (e.g. as in ‘portfolio management’ as opposed to ‘managing an AIF’).‘ Note that this is a **different approach** to when calculating the ‘funds under management requirement’ (IPRU(INV) 11.3.2) where the value **excludes** funds managed **under delegation**.

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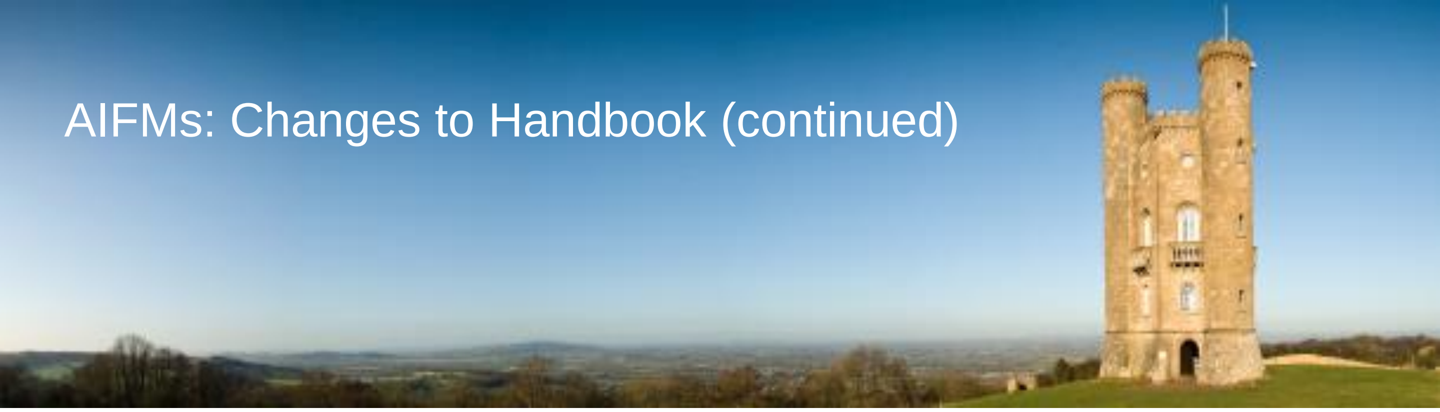
AIFMs: Changes to Handbook (continued)



- SUP 16.18 (‘AIFMD Reporting’) will be amended to confirm that **non-EEA AIFMs** and small **registered** UK AIFMs will also be subject to a £250 admin fee for not submitting Annex IV reporting (technically these types of entities do not fall within the definition of ‘firms’ and so fall outside the admin fee penalty as it is worded in SUP 16.3.14).

- SUP 16.18 will be amended to clarify that **UK AIFMs** of **non-EEA AIFs** that are **not marketed** in the UK or EEA (table in SUP 16.18.4 only refers to **EU AIFs** <u>managed</u> or **AIFs** <u>marketed</u> in the Union) are subject to the same reporting periods and end dates as if it was marketed in the EEA.

- As you know, an AIFM can also be authorised to undertake additional MiFID-type activities e.g. investment advice (a ‘non-core activity’ as is safe-keeping and Reception & Transmission of Orders) but if so then one of those activities for which it will be authorised **must** be portfolio management (a ‘core activity’ as is ‘managing an AIF’ or ‘managing a UCITS’). It is the view of the FCA that provided a UK AIFM is carrying out (legally) any non-core activities in the UK then it is permitted to carry out those non-core activities in any other EEA State under the **management passport without** the need to also passport out any core activities. On the same basis the FCA will also accept passport applications from EEA AIFMs in respect of only non-core activities. FUND 10.2 is amended accordingly. However AIFMs should note that they are warned (FUND 10.2.2A(2)) that the relevant EEA Host State regulator may not share the FCA’s views and therefore firms should seek legal advice.

- FUND 3 will have guidance, in the form of FAQs, added (‘3 Annex 3G’) on what constitutes the **valuation function** under the AIFMD – basically it is the person that makes the **final** determination on the value of the asset, so price providers or input from third-parties would not be performing the ‘valuation function’ (the definition is relevant in that external valuers need to be notified to the FCA whilst internal valuation requires segregation – see FUND 3.9). Having said that, Q1.3 clarifies that e.g. the board of a corporate AIF that retains a contractual right to **override** a valuation figure does **not** mean that they are performing the ‘valuation function’, provided it only exercises this right on an exceptional basis.

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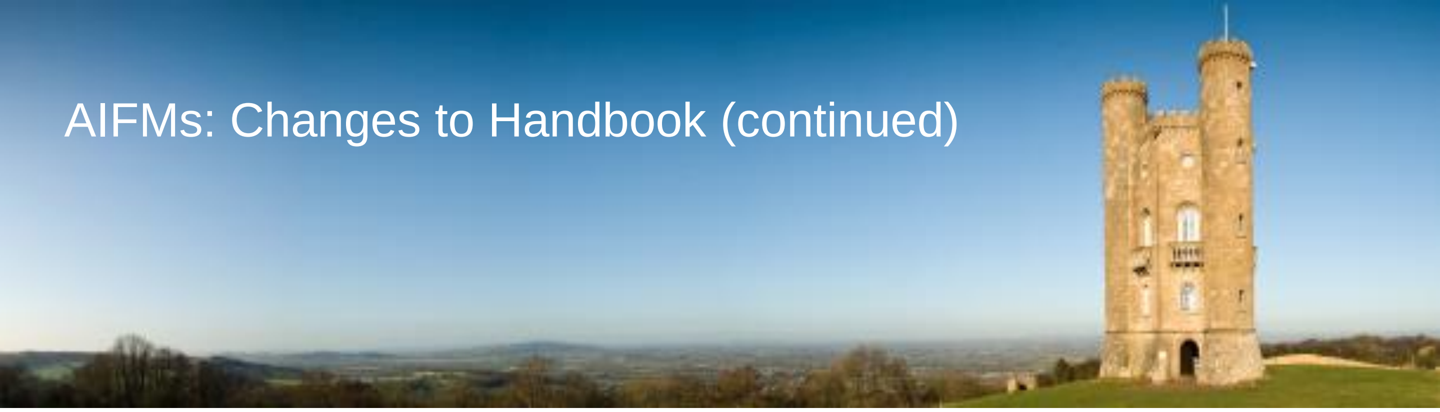

AIFMs: Changes to Handbook (continued)

- One of the requirements for marketing non-EEA AIFs (or marketing by a non-EEA AIFM) under the AIFMD concerns the need to ensure that the non-EEA country does not appear on the ‘**FATF Non-Cooperative Country**’ list. As has been pointed out previously, no such list of that name exists. FUND 10.5 will clarify that this should be interpreted as a jurisdiction that appears in the ‘FATF Public Statement’.

- FUND 10.5.14 will provide guidance on determining the place of establishment of an AIF, which will be relevant for applying the marketing requirements.

Comments on the proposed changes are invited by **5 May**.

FATCA Reminder

Useful links:

[HMRC Guidance: August 2014]

[HMRC: FATCA Submissions]

[HMRC: FATCA Registration]

[UK Regulations SI 2014/1506]

[IRS Portal]

A reminder to those firms subject to FATCA that the first return (in respect of 2014) must be submitted to HMRC by 31 May 2015 (‘the reporting date’).

It may be recalled that as far as UK firms are concerned, reporting in accordance with FATCA requirements will be to HMRC and not to the US IRS. Having said that, reporting firms will, of course, still need to apply to the IRS in order to obtain a GIIN (Global Intermediary Identification Number). All firms subject to FATCA requirements should by now have obtained their GIIN, but in case there is still some last-minute housekeeping outstanding an application can be made via the IRS portal.

A link to the latest (August 2014) HMRC Guidance is provided. Section 9.3 (page 169) contains a useful reporting timetable. As will be seen, the information that needs to be reported is being gradually phased-in until 2017.

Although a review of this Guidance was scheduled for February, at the time of this article the August 2014 version is the most recent available.

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Compliance Officer Prohibition

Useful links:

Final Notice: Mr Bell

Final Notice: Investments Ltd

Final Notice: Financial Ltd

The publication of three Final Notices reminds us that the FCA may not simply restrict its actions to authorised firms (in this case Financial Ltd and Investments Ltd) but can also pursue an **individual** (Mr Stephen Bell).

Although the firms in question together formed an adviser network of around 250 Appointed Representatives (AR) and 300 Registered Individuals (RI), the basic principles behind the findings within the Final Notices will be relevant to many firms.

Mr Bell was the **Compliance Director** at both firms and at various times his roles also included the **CF10** (Compliance oversight) and **CF11** (Money laundering reporting) functions.

Not for the first time at the heart of the Final Notices was an issue with **poor systems and controls**. In Mr Bell's case the Notice highlights inadequate training and development of RIs, including competency assessments and a failure to **identify and manage risks** that the firms might be exposed to. Whilst the Final Notice acknowledges that Mr Bell worked within the context of the firms' business model and cultural focus; that he **instigated improvements** to file checking; and that he "took significant steps … to introduce and improve the firms' compliance systems and controls", these were deemed 'ultimately insufficient' to ensure that the firms complied with the relevant regulatory regimes. The Notice also explains that the firms have previously been subject to investigation by the Regulator (in connection with a thematic review of pension-switching) and a subsequent Skilled Persons Review.

In a press release Georgina Philippou, the FCA's acting director of enforcement and market oversight Division, said that "this action shows that a compliance director of a network has an important role in terms of ensuring that systems and controls across the network are focussed on minimising the risk of mis-selling and the provision of unsuitable advice to consumers. We view Mr Bell's failings as particularly serious because he had been put on notice of the need for significant improvements in the firms' systems and controls and compliance". If one removes references to 'network' and 'mis-selling' this is effectively a reminder of the FCA's expectations placed upon the shoulders of 'senior management' and in particular those with a responsibility for compliance with the regulatory regime.

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Compliance Officer Prohibition (continued)

Mr Bell was subjected to both a financial penalty, after an ‘early stage’ 30% discount, amounting to **£33,800** and an order **prohibiting** him from performing the **CF10** function; the Final Notice does not specify any time period.

For the record, the FCA considered that a financial penalty of **£12,589,134** on Financial Ltd was appropriate but because of the financial hardship that this would cause the penalty was reduced to nil. However the FCA also imposed a 126 day restriction on the firm from appointing any AR or RI. A similar approach was taken with Investments Ltd (where the penalty would have been **£621,583**).

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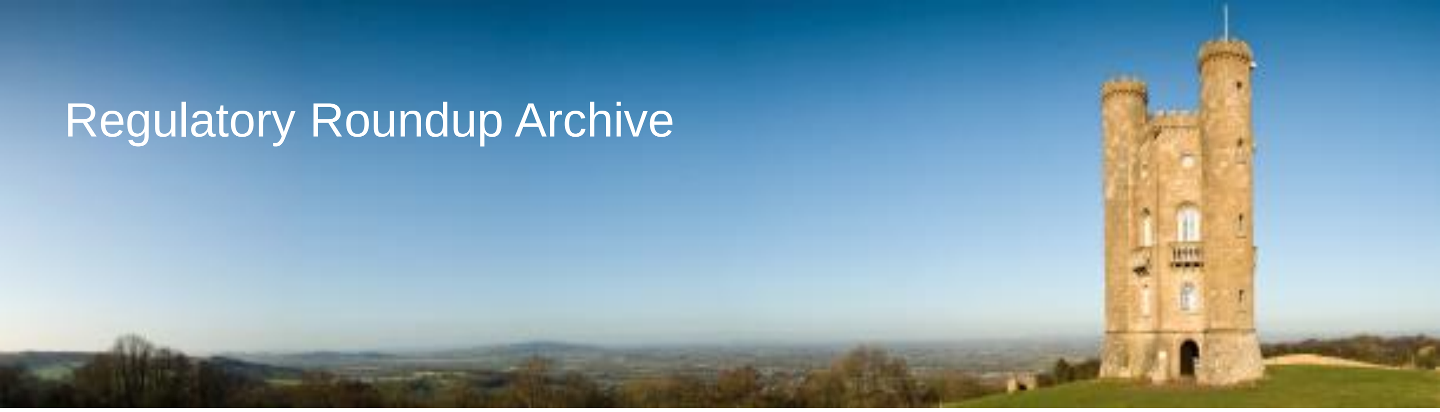

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[Peter Carlisle]

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