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Regulatory Roundup

15 January 2015
Issue 61

In Brief:

Regulatory Fees and Levies: Proposed policy changes to fee and levy regime

FCA Strategy Review: Structural reorganisation needed as number of FCA firms treble in 18months

PRIIPs: Key documents for PRIIPs come into force

European Long Term Investment Funds: Proposed ELTIF takes significant step forward.

MiFID 2: ESMA has published both its MiFID 2 Consultation Paper (2014/1570) and its Final Report on technical advice to the European Commission.

UCITS Share Classes: Differing national practices prompt publication of Discussion Paper 2014/1577 – "Share classes of UCITS".

Regulating Sonia: SONIA (Sterling Overnight Index Average) is one of seven benchmarks which will come under FCA regulation from 1 April 2015.

SEC Inspection Priorities: On 13 January 2015, the SEC's Office of Compliance Inspections and Examinations released their 2015 Examination Priorities.

Fourth Money Laundering Directive : 4MLD continues to progress following European Parliament and European Commission deal.

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If any of the topics discussed above raise questions or a need for guidance or support, please feel free to contact Peter Carlisle.

Regulatory Fees and Levies

Useful links:

[Regulatory Roundup 52]

[CP14/26]

[CP14/11]

The FCA has published CP14/26 – "Regulatory fees and levies: policy proposals for 2015/16". As was the case in last year's CP13/14 (see Regulatory Roundup 52), the purpose of the paper is to propose policy changes to the fee and levy regimes – a consultation on fee rates to be charged for 2015/16 will not appear until around March/April of next year.

As most will be aware there is a new regulator in being (**Payment Systems Regulator** (PSR) – a subsidiary of the FCA) – which will be responsible for the regulation of Visa, CHAPS, Bacs etc., although it will not be fully operational until next April. The set-up costs of the PSR are expected to be in the order of £12m to £14m which CP14/26 proposes to reclaim in full in 2015/16 rather than recover over a period of time. This will be in addition to the ongoing regulatory activities cost, expected to be around £13m to £16m.

It was originally proposed that the **pensions guidance levy** (see CP14/11 – the FCA is required to recover the costs of providing pensions guidance from authorised firms and remit to Treasury) be raised from five fee-blocks including **A.7** (portfolio managers), **A.9** (managers and depositaries of investment funds and operators of collective investment schemes or pension schemes) and **A.13** (advisory arrangers, dealers or brokers). The FCA acknowledges that not every firm in these fee blocks will provide retirement financial products and services and in the light of this CP14/26 proposes some modest **adjustments** including the exclusion of in-house managed Occupational Pension Schemes from **A.7**. Table 4.1 in CP14/26 (page 29) shows the final proposed allocation of the pensions guidance levy with A.13 accounting for 12% whilst the remaining four fee-blocks each bear 22%.

FCA **authorisation application fees**, which have not changed since first set by the FSA in 2001, have also come under the microscope. At that time these fees covered between 50% and 90% of FSA's costs (straightforward cases and complex cases respectively) although as a result of inflation the fees now cover only around 35% of the FCA's processing costs. For now, the FCA is not putting forward any proposals for consultation.

Elsewhere the paper proposes drafting changes to clarify 'income' in respect of fee-blocks A.9, A.13 and A.14 (corporate finance advisers).

Comments are invited by 2 February 2015.

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FCA Strategy Review

Useful links:

[FCA Strategy]

[FCA Statement on Departures]

[FCA Interim Organisation Chart 2015]

[Regulatory Roundup 54]

With the regulation of consumer credit having come under the wing of the FCA last April, the number of firms that the FCA is responsible for has trebled over the past eighteen months.

The Regulator has seen the need to provide a 'sharper focus' in its approach and hence firms will see a structural reorganisation so that the FCA can ensure the right outcome for consumers and the markets.

Possibly of most interest to firms will be the, temporary, merger of **Authorisations** and **Supervision** under the control of Tracey McDermott until April when two new Divisions will be created "allowing for a clearer distinction between our approach to the regulation of large and smaller firms". The sharpening of focus will include the removal of the distinction between **C3** and **C4** firms and supervising individual firms on a more risk-based model; Regulatory Roundup 54 provides further details of the current supervisory approach to C4 firms, being the categorisation under which the vast majority of firms fall within.

Elsewhere changes will include the creation of a new Risk Division and a Market Oversight Division which will incorporate UKLA and Market Monitoring functions; we are advised that other specialist market supervision functions will be integrated with Supervision.

The structural changes, which commenced on 5 January 2015 and will be fully in place by 1 April 2015, will see the **departure** of **Clive Adamson** (Director of Supervision), **Zitah McMillan** (Director of Communications and International) and **Victoria Raffe** (Director of Authorisations).

The links provided include 'before and after' charts, although note that **Lesley Titcomb** (Chief Operating Officer) will also be leaving at the end of January to become CEO of The Pensions Regulator.

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PRIIPs

Useful links:

[Regulation 1286/2014]

[Corrigenda]

Regulation 1286/2014 on the provision of **Key Information Documents** (**KID**) for Packaged Retail and Insurance-based Investment Products (**PRIIPs**) came into force on 29 December 2014 – although it will not apply in Member States until **31 December 2016 -** so giving impacted firms sufficient time to put into place necessary changes to processes and procedures. Being a Regulation, rather than a Directive, the rules will have a direct effect on Member States without the need for any individual legislation within each State.

The Regulation will apply to both those persons advising on, or selling, PRIIPs and to PRIIP 'manufacturers'. The definition of the latter isn't that well defined ("any entity that manufactures PRIIPs ... or makes changes to an existing PRIIP..."), although Recital (12) does reference "PRIIP manufacturers – such as fund managers, insurance undertakings, credit institutions or investment firms ...".

The intention of the Regulation is to make available adequate, and consistent, information to a retail investor before investment; Articles 6 to 8 sets out the required form and content of the KID, including the requirement that it should consist of a maximum of three sides of A4-sized paper when printed.

A PRIIP, which is not quite the same as the 'Retail Investment Product' or the 'Packaged Product' that both appear in the FCA Handbook, is defined in Article 4 and is broadly 'a product' that is exposed to market fluctuations, so a 'fund' would be captured but not an individual share. Certain products are specifically **excluded** from the definition of a PRIIP (Article 2) including pension products, occupational pension schemes and deposits. It will be noted from Article 4 that a PRIIP can be either a Packaged Retail Investment Product **or** an Insurance-based Investment Product (or both).

Penalties for infringement of relevant Articles can be an 'administrative fine' of at least up to €5m for a legal entity (€700k if a natural person) or up to twice the amount of the relevant profits gained or losses avoided.

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PRIIPs (continued)

European Long-Term Investment Funds

As mentioned above, the Regulation applies from **31 December 2016**. However there is an **extension** to 31 December 2019 for **UCITS Management Companies** (Article 32); the extended time frame reflects the fact that UCITS schemes are already required to have something similar - a Key Investor Information Document (**KIID**) (see COLL 4.7.2). Having said that, the Commission is required to review the situation by the end of 2018 to see whether this transitional arrangement should be prolonged or whether the KID should replace the KIID.

Useful links:

[ELTIFs Compromise Text]

[Regulatory Roundup 50]

The proposal to create a further type of fund vehicle – European Long-Term Investment Funds (ELTIFs) – has taken a significant step forward in that the European Council has approved a compromise with the European Parliament (see link to compromise text).

Regulatory Roundup 50 advised that an ELTIF is designed to be a long term investment to provide monies for projects such as infrastructure development. As such, an ELTIF will set a specific term for the vehicle before which an investor will not be able to request redemption (although the Regulations allow the possibility of both a temporary extension of the term period and early redemption). Having said that, the Regulations do not prohibit the shares or units in an ELTIF from being traded on a regulated market or MTF.

Although only EU AIFs will be able to market themselves as ELTIFs, the vehicle will be open to both retail investors that meet specific parameters and investment by UCITS. In addition the authorisation of an ELTIF will be valid for **all** Member States.

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MiFID 2

Useful links:

ESMA CP 2014/1570

ESMA CP 2014/1570 - Annex A (CBA)

ESMA CP 2014/1570 - Annex B (TS)

ESMA Final Report 2014/1569

MiFID 2014/65/EU

MiFIR 600/2014

ESMA had a busy period in the run up to Christmas with the publication of both its 645 page MiFID 2 **Consultation Paper** (2014/1570) on 19 December (together with a cost benefit analysis (CBA) and draft technical standards (TS) which provide an additional 978 pages) and its 446 page **Final Report** on technical advice to the European Commission.

Like the current MiFID, MiFID 2 actually consists of both a **Directive** (MiFiD 2014/65/EU) and a **Regulation** (MiFIR 600/2014) both of which require supporting **technical standards** to be developed by ESMA – hence the above flurry.

MiFID 2 will apply from **3 January 2017** but before then we can expect consultation papers from both HM Treasury (in respect of the necessary changes to UK legislation) and the FCA (Handbook changes). As with previous Directives and Regulations, Complyport will be working with its clients to ensure that they will be fully compliant with MiFID 2.

Some areas of MiFID 2 worth highlighting include:

- the **recording** of telephone conversations etc. will need to be kept for at least **5 years** and possibly up to **7 years** – COBS 11.8.10 currently requires at least 6 **months**. It should be noted that the current recording requirements in COBS 11.8 stem from an FCA initiative and not MiFID. The **discretionary investment manager** exemption (COBS 11.8.6) is **not** reflected in MiFID 2 (it refers to the recording of communications relating to the reception, transmission and execution of client orders **or** in the **provision of client order services** that relate to those activities) (MiFID Article 16(7)).

- the need for **transaction reporting** (SUP 17) currently depends upon whether the (or if an OTC derivative whether its value is dependent upon an) instrument is admitted to trading on a regulated or prescribed market. MiFID 2 extends transaction reporting to instruments admitted to trading on a **trading venue** which has a broader definition (MiFIR Article 26 & MiFID Article 4(1)(24)).

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- '**local public authorities**' and '**municipalities**', which may have slipped within the definition of a 'per se' professional client will have to pass an 'elective' professional test (although Member States will be allowed to adopt specific criteria to assess the expertise and knowledge of such entities) failing which they will have to be classified as **retail** (MiFID Annex II & Recital 104).

ESMA will consider all comments (which must be submitted in accordance with the instructions within the Consultation Paper) received by **2 March 2015**.

Useful links:

ESMA 2014/1577

ESMA has identified **differing national practices** in the interpretation of the types of share classes that are permitted under UCITS and, in the light of this, has published Discussion Paper 2014/1577 – "Share classes of UCITS".

For the avoidance of doubt a 'share class' is not the same as a 'sub-fund'. The latter is effectively a **compartment** of a UCITS which has different characteristics e.g. investment strategy from other sub-funds. One would expect the assets of sub-funds to be segregated so that any liability arising in one of these compartments cannot be offset by the assets of other compartments. On the other hand a share class is a category of share of the same UCITS e.g. one share class may be denominated in € whilst another may be in £ or they may have different fee structures etc.

The Paper sets out initial thoughts on what could legitimately fall under the heading of 'share class' – funds aimed at institutional investors vs. retails investors is one example – and those which do not seem compatible with the concept, say share classes that differ in terms of leverage.

Although the intention is to establish a common position on the use of share classes by UCITS, ESMA will take into account the possible impact on current market practices when developing its final position on the topic.

Comments are invited by 27 March 2015.

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Regulating Sonia

Useful links:

CP14/32

HMT Recommendations

SONIA (Sterling Overnight Index Average) is one of **seven** benchmarks which will come under FCA regulation from **1 April 2015**.

As will be known, currently **LIBOR** is the only regulated benchmark – MAR 8 contains the rules and guidance applicable to both benchmark submitters and benchmark administrators.

The decision to bring the further benchmarks within the regulatory perimeter was not a unilateral move by the FCA but rather implements recommendations made by HM Treasury arising from the (ongoing) Fair and Effective Markets Review which is led by the Bank of England, the Treasury and FCA. The regulation of financial benchmarks at EU level is also currently under consideration by the European Parliament and Council, although there is no clear indication of when appropriate European legislation will become a reality.

The FCA's proposals have been published in **CP14/32** ('Bringing additional benchmarks into the regulatory and supervisory regime') - Annex 1 of CP14/32 contains a useful description of the seven benchmarks. Although largely aimed at benchmark administrators, and submitters where applicable, the paper may also be of interest to those firms that use these benchmarks as part of their business operations.

Comments are invited by 30 January.

SEC Inspection Priorities

Useful links:

2015 Examination Priorities

Press Release

On 13 January 2015, the **Office of Compliance Inspections and Examinations** (“OCIE”) of the United States Securities and Exchange Commission (the “SEC”) released their 2015 Examination Priorities.

The SEC Examination Priorities identify OCIE’s high priority examination areas for 2015. For **SEC-regulated firms**, whether **Exempt Reporting Advisers** or **full SEC-registrants**, these priorities provide guidance for developing firms’ compliance monitoring programmes for 2015 and provide insight into the SEC’s perception of high risk areas.

The examination priorities focus on issues involving investment advisers, broker-dealers, and transfer agents and focus on three thematic areas:

1. Examining matters of importance to retail investors and investors saving for retirement, including whether the information, advice, products, and services being offered is consistent with applicable laws, rules, and regulations;
2. Assessing issues related to market-wide risks; and
3. Using the SEC’s evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

Many of the 2015 exam priorities focus on **recurrent areas** from the past examination priorities and recent risk alerts. Areas of focus in the 2015 Examination Priorities that have appeared in past examination priorities and risk alerts are:

- **Fee Selection and Reverse Churning**- Where an adviser offers a variety of fee arrangements, the SEC will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships.
- **Sales practices**- The SEC will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts.

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SEC Inspection Priorities (Continued)

- **Suitability**- The SEC will evaluate registered entities' recommendations or determinations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made, and the suitability of the recommendations or determinations are consistent with existing legal requirements
- **"Alternative" Investment Companies**- Pursuant to a January 2014 Risk Alert, the SEC will continue to assess funds offering alternative investments and using alternative investment strategies. So called "liquid alt" funds.
- **Clearing Agencies**- The SEC will continue to assess market wide risk by conducting annual examinations of all clearing agencies designated systemically important.
- **Cybersecurity**- Following on the heals of a April 2014 Risk Alert, the SEC will continue its initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls
- **Microcap Fraud**- The SEC will continue to examine operations at broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting , pump-and-dump schemes or market manipulation.
- **Anti-Money Laundering**
- **Never-Before-Examined Investment Companies**- The SEC will continue to conduct focused, risk-based examinations of selected registered investment company complexes that have not been examined.

The **new areas** of focus in the SEC 2015 priorities should come as no surprise to SEC-regulated firms as many have been touched on in speeches or flow directly from new regulation. Areas like (a) **Fees and Expenses** in **Private Equity** and (b) **Fixed Income Investment Companies** are a natural extension of the recurring priorities given that a many new advisers have come under the SEC's purview with the implementation of Dodd-Frank and the current economic and investment environment. **Additional** examination priorities include:

- **Branch Office supervision by registered entities**
- **Large Firm Monitoring**

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SEC Inspection Priorities (Continued)
Fourth Money Laundering Directive

- **Potential Equity Order Routing Conflicts**
- **Recidivist Representatives**
- **Excessive Trading**
- **Municipal Advisers**
- **Proxy Services**

Conspicuously missing from the 2015 Examination Priorities is Safety of Assets and Custody which has appeared in each of the last two years' releases. Despite its omission, the SEC will undoubtedly be interested in firms' compliance with Rule 206(4)-2, the "Custody Rule".

Firms subject to SEC Inspection, including **Exempt Reporting Advisers** and **SEC-registered firms**, should read and carefully assess the applicability of the priorities to their business.

Useful links:

Press Release

Regulatory Roundup 60

The (fourth) Money Laundering Directive (4MLD) continues to progress through the European machinery following a deal having been struck by the European Parliament and European Commission just before Christmas. A **press release** issued by the Parliament on 17 December reminds us that a key element of 4MLD is the requirement for the creation of central registers to hold information on the **beneficial ownership** of corporate and other legal entities – see Regulatory Roundup 60.

We are advised that the deal still needs to be endorsed by various internal committees, including the Committee of Permanent Representatives (COREPER), before being put to the vote by the full Parliament later this year.

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