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Regulatory Roundup

28th August 2014
Issue 58

In Brief:

Best Execution and Payment For Order Flow: Following a thematic review of best execution the FCA has now published the results of its findings.

New Remuneration Code: The FCA and PRA have issued a joint Consultation Paper: 'Strengthening the alignment of risk and reward; new remuneration rules'.

Connect vs. ONA: A reminder that the FCA's Online Notifications and Applications system (ONA) will be largely replaced by a new online system – 'Connect'.

AIFMD Reporting: ESMA Guidelines: ESMA updated its AIFMD Reporting Guidelines earlier this month which AIFMs may find useful.

Recovery and Resolution: Impact of Recovery and Resolution Directive.

Retrospective Application of Rules: The FCA is reaching out to the industry for examples where it is believed that the FCA has applied its rules retrospectively.

EMIR Review: The FCA has undertaken a review on how industry dealt with the new obligations under EMIR

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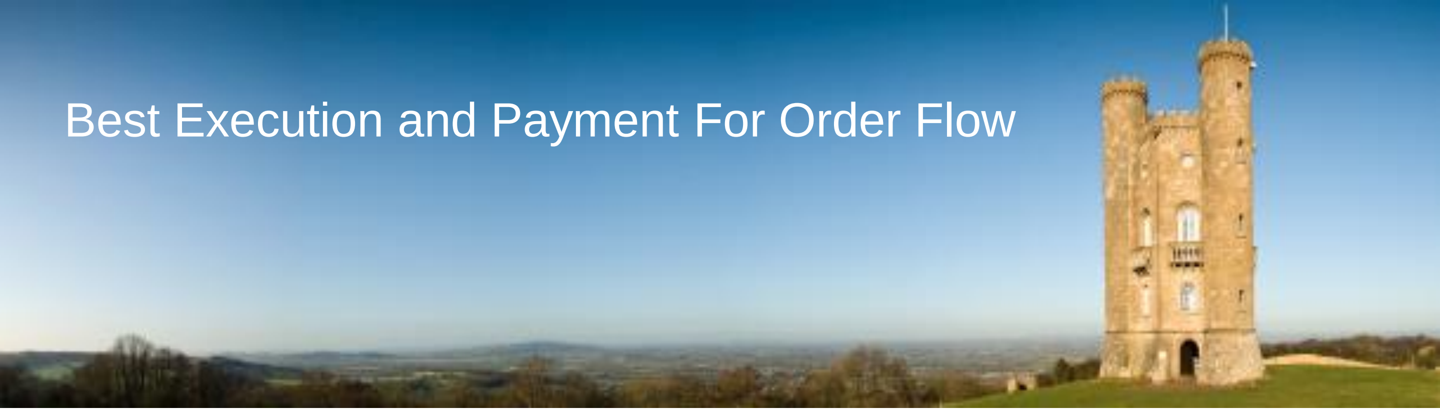

Best Execution and Payment For Order Flow

Useful links:

[Regulatory Roundup 53]

[Regulatory Roundup 55]

[Regulatory Roundup 57]

[TR14/13]

[Guidance: Payment for Order Flow]

[Best Execution: EC Opinion]

Following a thematic review of **best execution** (see Regulatory Roundup 53) the FCA has now published the results of its findings – TR14/13: "Best execution and payment for order flow". As will be apparent from the title the FCA took the opportunity to incorporate into the review the practice of Payment for Order Flow (PFOF) to see how firms have responded to the Guidance issued in May 2012.

The review did not involve questioning or visiting **buy-side firms** but the Executive Summary makes it clear that the paper is relevant to all firms '**including portfolio managers**'. For the avoidance of doubt, although the obligations of e.g. portfolio managers are generally set out in COBS 11.2.30 – 11.2.33 they will need to consider COBS 11.2 as a whole should they also execute the decisions to deal on behalf of a client's portfolio.

The findings from the review, which took in a total of **36** firms ranging from CfD providers to wealth managers, makes depressing reading with the general overview that:

- most firms are not doing enough to deliver best execution
- firms need to improve understanding of the scope of their best execution obligations

We are reminded that 'best execution' is **not** the same as 'best price' but instead takes in a range of 'execution factors' (albeit that the FCA would expect price to merit a high relative importance for a professional client and 'total consideration' – representing the price and the costs related to execution - for a retail client: see COBS 11.2.9 & COBS 11.2.8).

A key risk area identified was firms' understanding of the application of best execution to **quote-driven** markets (see COBS 11.2.4) with many firms found to be seeking to limit the application of best execution in such instances without giving due consideration to the '**legitimate reliance**' test i.e. acting 'on behalf of the client' as in whether the client is relying on the firm to protect their interests in relation to pricing etc. For retail clients the assumption is that the client **does rely** on the firm, with the opposite

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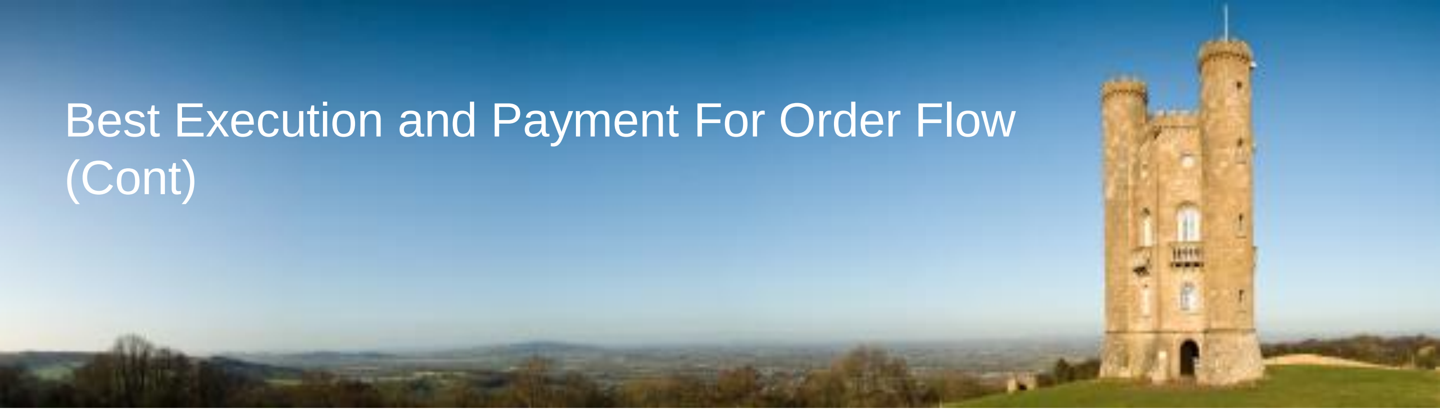

Best Execution and Payment For Order Flow (Cont)

assumption for professional clients **but s**ubject to meeting the EC four-fold legitimate reliance test – see page 44 for further information, which is based upon **EC Opinion on best execution** (see link).

A further key risk area identified was when a firm **deals on its own account** with clients; such a firm must not overlook that they may still be 'acting on behalf of clients'. As such, executing a client order against a firm's own proprietary position where the firm is making decisions as to how the order is executed (working the order on the client's behalf) will mean that there is a **duty of best execution** as the firm is effectively **competing** with other execution venues. Dealing as a **riskless principal** on behalf of a client would also give rise to a **best execution obligation**. In contrast, if the firm was engaging in proprietary trading on a **request for quote basis** then it is probable that there is **no** best execution obligation - again the 'legitimate' test will need to come into play.

Monitoring also came under criticism with 'most firms' lacking effective monitoring capability to identify best execution failures or poor client outcomes. The FCA does not share the view that clients would switch to a competitor if best execution was not being consistently delivered as this placed reliance upon the clients rather than the firm to ensure best execution. Although there was evidence that some sophisticated clients sometimes detected issues before the firm itself this could also mean that the less sophisticated clients are likely to suffer from best execution failures on a disproportionate basis.

FCA expectations are that **ownership** of best execution monitoring resides with **front-office** but with an adequately equipped **second line of defence** to challenge conclusions reached by execution desks.

As for PFOF, the FCA view that the practice creates a conflict of interest between a firm and its clients remains. Although a few of the firms visited in the sample continued to receive PFOF, by the time of publication of TR14/13 all the firms confirmed that they had ceased receiving PFOF. Page 47 details arguments put forward by the Future and Options Association and the Wholesale Markets Brokers Association in favour of the practice but rejected by the FCA.

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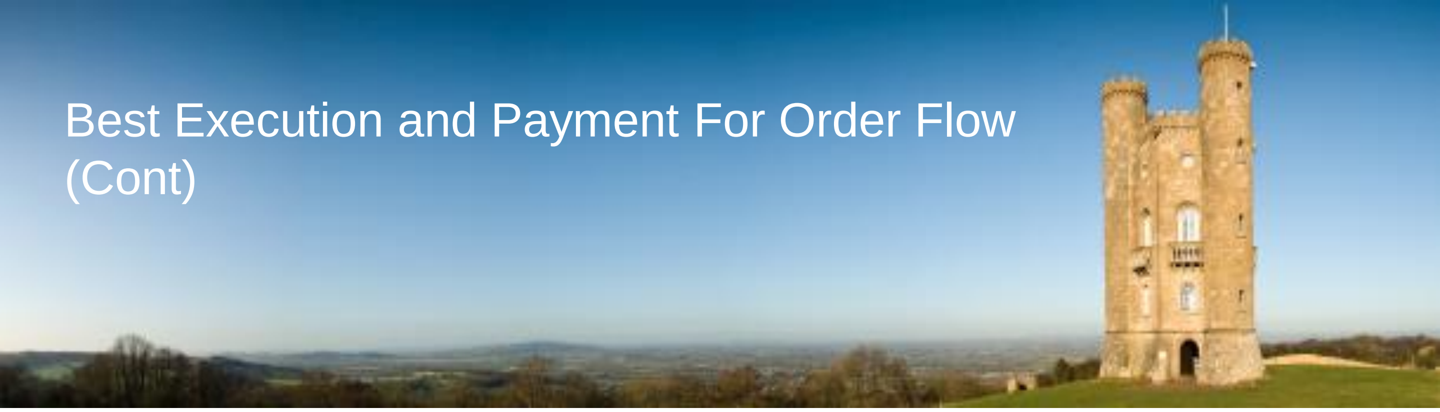

Best Execution and Payment For Order Flow (Cont)

Firms should note that the findings have led the FCA to include both best execution and PFOF as two of the potential competition areas which the Regulator may study in more detail (see Regulatory Roundup 57 'Wholesale Markets: Competition') so these issues will remain on the FCA radar as part of its **wholesale conduct strategy** which includes the need for "firms to put their clients' best interests at the heart of their business strategy". With this in mind it will be recalled that the FCA has also recently released Policy Statement PS14/7 on the use of **dealing commission** (see Regulatory Roundup 55) and Discussion Paper DP14/3 on **dealing commission unbundling** (see Regulatory Roundup 57).

Actions:

All investment firms should review their best execution arrangements (and PFOF if relevant). Note that **senior management** also have a role to play in demonstrating the delivery of best execution on a consistent basis (see page 9). Chapter 3 contains examples of **poor practice** e.g. total exclusion from best execution for clients who chose to deal on a quote basis without consideration of the four-fold reliance test or relying on clients to 'shop around' before dealing on quotes, and which firms can use as a marker for their own procedures. The review should not overlook the importance of effective monitoring and examples of both poor and good practice are provided e.g. sample size, unsuitable tolerances and an overreliance on **VWAP**. Providers of **CfDs** are seen as presenting additional risks and note should be taken of page 18 onwards.

When reviewing current procedures, firms should also consider the implications of **MiFID II** (Article 27) – which should come into application early 2017 - in respect of best execution (a link to MiFID II appears in Regulatory Roundup 57). The current requirement to take 'all **reasonable** steps' to obtain the best possible result for the client will be replaced by 'all **sufficient** steps'. Article 27(6) will require firms to **make public** on an annual basis, for each class of financial instruments, the **top five execution venues** and information on the quality of execution obtained which, for some firms, may mean enhanced monitoring procedures.

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New Remuneration Code

Useful links:

[CP14/14: New Remuneration Rules]

[Handbook Notice 13]

The FCA and PRA have issued a joint Consultation Paper: ‘Strengthening the alignment of risk and reward; new remuneration rules’ (CP14/14 – or CP15/14 from a PRA perspective).

As will be known, SYSC 19 currently concerns the Remunerations Codes for IFPRU firms (SYSC 19A); full-scope UK AIFMs (SYSC 19B); and BIPRU firms (SYSC 19C) – although the recently introduced SYSC 19C.1.1A relieves BIPRU firms that are also full-scope UK AIFMs from having to demonstrate compliance with SYSC 19C (unfortunately the same is not true of those AIFMs that happen to be IFPRU firms – see 3.40 of Handbook Notice 13).

The proposed changes have largely been brought about following publication last year by the Parliamentary Commission on Banking Standards and so will affect **banks** and **building societies** as well as the (currently nine) dual regulated investment firms (‘designated investment firms’); there will also be some modest knock-on effects for other firms as a result of changes that will be made to the Handbook.

The impact of the proposals will be to remove the banks and building societies and the dual regulated investment firms from SYSC 19A and to provide them with their own dedicated chapter: SYSC 19D. As a consequence SYSC 19A, which will be renamed ‘IFPRU Remuneration Code’, will only apply to IFPRU investment firms and certain overseas firms.

The proposed Rule and Guidance changes for FCA regulated firms can be found in **Appendix 5** whilst Proportionality Guidance for those dual regulated firms subject to SYSC 19D as well as the consequential changes to the Proportionality Guidances for firms subject to SYSC 19A and SYSC 19C can be found in **Appendix 7**. The consultation period ends 31 October with the intention that all the new Rules will come into force for awards made for **performance periods** starting on or after **1 January 2015**.

Whilst the changes are fairly modest for those firms remaining subject to SYSC 19A or SYSC 19C, obviously those firms that will fall under SYSC 19D

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New Remuneration Code (Cont)
Connect vs. ONA
AIFMD Reporting: ESMA Guidelines

should review the requirements in the light of their current processes, controls and procedures to ascertain what changes may be required e.g. a variable remuneration **deferral period** of up to **seven years** (SYSC 19D.3.59(1)(b), a **clawback period** of at least **seven years**, and in certain circumstances, a period of at least **ten years** (SYSC 19D.3.61(3)&(4)) etc.

This will expand SYSC 19 to four separate chapters and possibly it will be enlarged further when UCITS V and its associated remuneration requirements come into force.

Useful links:

FCA Connect

FCA Web page

A reminder to firms that the FCA's Online Notifications and Applications system (**ONA**), under which applications for Approved Persons, Variations of Permission etc. are submitted, will be largely replaced by a new online system – '**Connect**' – from 1 October (although **passport** applications will remain on **ONA**). For the avoidance of doubt, paper based submissions such as a Change in Control will remain on paper.

The FCA has produced a one-page overview of Connect (see link) which advises that firms will need to register to make use of the system, although at the time of this article the process to achieve this is not clear.

ESMA Reporting Guidelines 2014/869

ESMA updated its AIFMD Reporting Guidelines earlier this month which AIFMs may find useful.

For the benefit of those firms that to date have not made reference to the ESMA guidelines their role is to ensure that there is a consistent approach to the AIFMD (and Level 2) reporting requirements across Member States. A variety of topics are covered ranging from when the first reporting is due to the reporting treatment of umbrella AIFs and master/feeder structures.

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Recovery and Resolution

Useful links:

[CP14/15]

[Recovery and Resolution Directive 2014/59]

[CRR 575/2013]

[EBA: Recovery Plans]

IFPRU 2.5 ('Recovery and resolution plans') is applicable to all IFPRU investment firms and has been in force since the beginning of this year.

It must qualify as one of the shorter chapters in the Handbook, consisting as it does of only two Rules.

The first rule was for a firm is to have in pace both a **recovery plan** for restoration of its financial situation following a significant deterioration **and** a viable **resolution plan** setting out options for the orderly resolution of the firm in the case of failure.

The second rule simply required the firm to cooperate with the 'resolution authorities' and to provide them with all necessary information for the drafting of their resolution plans.

The two rules were based upon **CRD Article 74(4)** and whilst the latter did contain reference to proportionality there was **no** similar reference to the application of proportionality in IFPRU 2.5.

Fortunately (unless you are an IFPRU 730K firm) the **Recovery and Resolution Directive** (2014/59) (RRD) has removed this requirement by virtue of Article 124 which deletes **CRD Article 74(4)**; in turn the definition of an 'investment firm' in the RRD is now one that satisfies CRD Article 28(2) i.e. an IFPRU 730K firm.

An important objective of the RRD is for the FCA (or the PRA for dual-regulated firms) to be able to identify when a firm is in financial distress with a view to early intervention. With this in mind relevant investment firms will be required to prepare and **submit recovery plans to the FCA**. On the other hand a firm's **resolution plan** will be drawn up by the **Resolution Authority** (RA) - CP14/15 confirms that the RA for the UK will be the Bank of England, or at least will sit within the Bank, based upon information provided by the firm. It is likely that the Bank will ask the FCA, on its behalf, to collect the required information. Note that the Consultation Paper concentrates upon the 'recovery' aspect rather than the 'resolution'.

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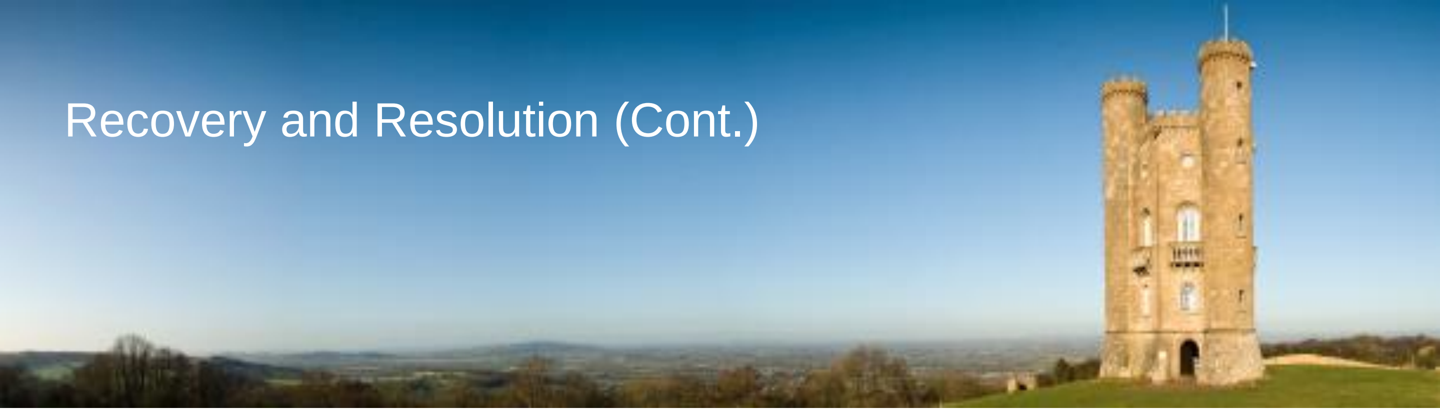

Recovery and Resolution (Cont.)

Once a ‘**trigger**’ is breached by a firm the FCA may intervene e.g. **replacing the firm’s management** or, if the firm is likely to fail, moving the firm into the **resolution phase**. In the latter case the RA may apply any resolution strategies necessary, including insolvency. Chapter 7 of CP14/15 consults on the metrics to be used to set appropriate ‘triggers’.

It is proposed to adopt proportionality and to apply simplified obligations, as allowed for under Article 4, to all but the largest firms; this would mean that of the approximately 230 FCA solo-regulated IFPRU 730K firms, around **190 firms** would be subject to the ‘**simplified application**’ of the obligations. To identify ‘**significant firms**’, which will not be able to apply the simplified obligations but instead will be subject to the ‘**general application**’, it is proposed to use the **same criteria** as for the identification of **significant IFPRU firms** (IFPRU 1.2.3) which, in brief, would be a firm meeting **any one** or more of the following thresholds: total assets exceeding £530m; total liabilities exceeding £380m; client money or client assets in excess of £425m or £7.8bn respectively; or annual fees and commission income exceeding £160m.

Both general application and simplified applications firms will have to **submit recovery plans to the FCA** (annually or every two years respectively), although, as might be expected, the contents for the latter type of firm will be less onerous – see IFPRU 11.2.5 and IFPRU 11.2.6 as to content. Firms will need to establish ‘**indicators**’ which identify the points at which appropriate actions referred to in the recovery plan may be taken. When considering recovery plans, firms should also be aware of the **EBA technical standards** and guidelines relating to the information to be included (see link). It is proposed that the **first reporting reference date** (firms will have three months from that date to submit their plans) will range from 30 June 2015 to 30 June 2016 depending upon size – see SUP 16.20 in CP14/15.

The draft rules, including the reporting requirements in the amended SUP 16, can be found in Appendix 1 of CP14/15. As will be seen, the current IFPRU 2.5 will be deleted in its entirety and that a new chapter (**chapter 11: Recovery and resolution**) will contain the new obligations. Note that application of ‘recovery and resolution’ extends to financial institutions

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Recovery and Resolution (Cont.)
Retrospective Application of Rules

(which is not the same as an 'institution'), financial holding companies etc. This is a complex area and firms should acquaint themselves with the list of firms in scope (see RRD Articles 1 and 2 which in turn refer the reader to the CRR 575/2013).

The consultation period ends 1 October with final rules expected in a December Policy Statement. The RRD has to be applied from **1 January 2015**.

Useful links:

[FCA Business Plan 2014-2015]

[Retrospective Application of Rules]

Amongst the various areas for action in the FCA's Business Plan for 2014/15 that was published in March was work to be carried out in respect of the '**expectations gap**'. This describes the relationship between the FCA Handbook and firms' perceptions of it and considers whether any differences in understanding might affect the quality of products and services that consumers receive. A concern would be whether market development was being held back by uncertainty around rules or concerns over **retrospection**.

The FCA has now reached out to industry and is calling for **examples** where it is believed that the FCA (or FSA) has applied its rules retrospectively, as in applying a more demanding standards or interpretation of the rules after the event with the **benefit of hindsight**.

Any examples provided will help feed into the Regulator's approach to the industry.

Comments are invited by 1 October. Information can either be sent in writing or by way of electronic submission – the 'Retrospective' web page (see link) provides further information.

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EMIR Review

Useful links:

[FCA: Is Industry Ready?]

[FCA: EMIR Q&A]

[ESMA: EMIR Q&A (July 2014)]

[Regulatory Roundup 56]

With reporting under EMIR having been in place for around six months, the FCA has undertaken a review to find out how industry dealt with the new obligations. It also took the opportunity to assess how the industry had prepared for the start of the collateral and valuation reporting which came in on 11 August (see regulatory Roundup 56).

A short summary appears on the FCA website.

The Regulator comments that the “vast majority” of derivative contracts are being reported and found that “the majority of reporting to be correct and successful” – some identified issues are included in the summary.

The summary can be accessed by way of the provided link. There are also links to the most recent EMIR-related Q&As issued by the FCA and by ESMA.

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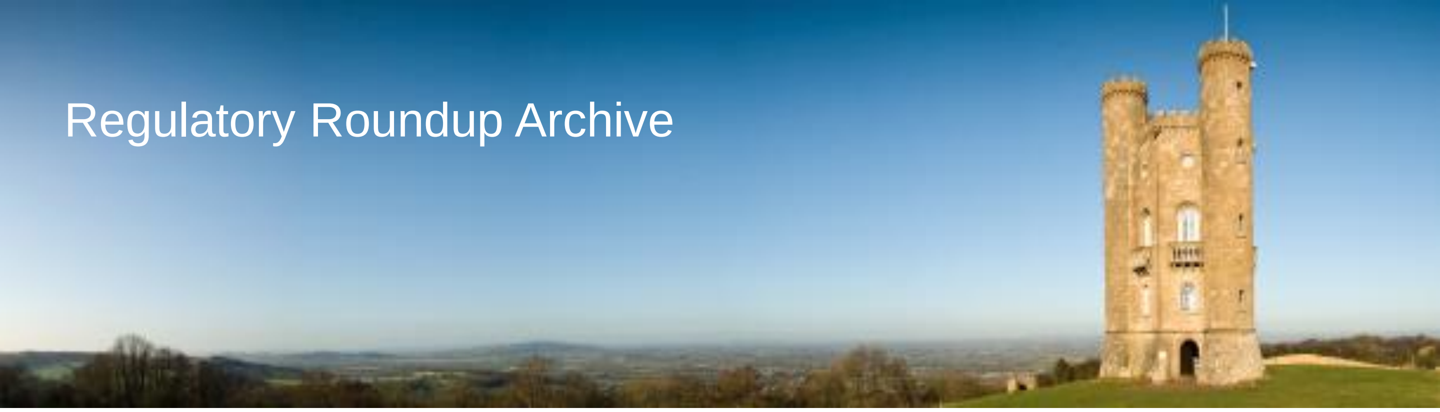

Useful links:

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