Linklaters

December 2013

Regulatory Investigations Update.

The developments contained in the final edition of this Update for 2013 reflect a number of the themes which have dominated FCA enforcement work during the past year. The recent fine imposed for bank failings in respect of sales incentives schemes is a reminder of the importance the new regulator attaches to the interests of consumers and its determination to challenge aspects of bank culture which operate against these. The decision in respect of the former Finance Director of Bradford & Bingley indicates the scrutiny to which the actions of senior mangers, even during times of financial turmoil, are now likely to be subject. With the detail of the new criminal offence for the directors of failed banks and the new senior persons regime to be finalised next year, and the results of the FCA's first market studies and work on behavioural economics available to further inform the pursuit of its competition objective, the FCA is likely to become still more aggressive in its approach as it moves into 2014.

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Section 166 review commissioned by RBS following reports into lending and treatment of small businesses

The Royal Bank of Scotland ("RBS") has agreed to appoint a skilled person under s.166 FSMA to investigate allegations made in two separate reports into its business practices (the "Review"). The reports, by Sir Andrew Large and Dr Lawrence Tomlinson, consider business lending practices at RBS and the treatment by RBS (and other banks) of corporate customers in financial difficulty respectively. Commenting on the latter, the FCA indicated that, although commercial lending is not a regulated activity, Dr Tomlinson's report raised concerns that RBS might not have treated customers fairly which, if substantiated, could be indicative of wider issues with governance and culture within the bank. The FCA has therefore agreed that a skilled person's report should be commissioned and has separately written to the CEOs of other banks requesting that the satisfy themselves that they are not engaging in the practices identified in either of the reports. Should the Review uncover evidence of regulatory breaches, formal enforcement action may follow. Commenting on the allegations, FCA Director of Supervision Clive Adamson reiterated that the regulator expects all firms to act with integrity and to put consumers at the heart of their business.

HM Treasury confirms investigation into Co-operative Bank

The Chancellor of the Exchequer, George Osborne, has ordered an independent investigation into the Co-operative Bank (the "Co-operative"). This follows the news in June this year that the bank had a £1.5bn capital shortfall and subsequent allegations concerning the behaviour of its former chairman, the Rev Paul Flowers. The investigation will consider events since 2008, including the Co-operative's takeover of the Britannia Building Society in 2009, the activities of directors and the actions of both regulators and the government.

The investigation is the first to be ordered under new statutory powers granted to the Treasury at s.77 Financial Services Act 2012 to require either the PRA or FCA to undertake an investigation and report back to the government. In the press release announcing the investigation, the Treasury stated that the investigation has been agreed with both the PRA and FCA, who will jointly appoint an independent person to lead it. Both regulators are also said to be considering whether to launch their own formal enforcement investigations, with the statutory investigation on hold until it is certain that it will not prejudice these (or any other) enforcement actions. A detailed direction ordering the independent investigation and setting out its terms will be laid before Parliament, as will the investigator's final report. In a separate statement the FCA welcomed news of the investigation.

FCA to investigate price comparison websites

The FCA has announced that it intends to review price comparison websites amid fears that they may not be operating in the best interests of consumers. Such sites have become extremely popular in recent years, with car and home insurance the most popular searches. The FCA is concerned that, as results are sorted purely on price, customers may be unaware of the high number of exclusions which tend to be contained within the cheapest policies, purchasing insurance that may be unsuitable as a result. Certain comparison sites are part owned by larger insurance firms and some are paid commission by insurers whenever a consumer "clicks through" to their website and purchases a policy, both of which are viewed as potentially compromising a site's impartiality. Claims that the final premiums charged can be higher than those quoted on sites will also be investigated. The review is expected to conclude in early 2014.

Concerns raised over proposed changes to consumer mortgage terms

The FCA has indicated that it is planning to publish a discussion paper before the end of the year considering the fairness of unilateral changes to mortgage contracts, including standard variable rates. This follows the announcement in October that both the Bank of Ireland and West Bromwich Building Society were to raise rates for customers with tracker mortgages, even though the Bank of England base rate remains unchanged at 0.5%. Customers have argued that this is unfair as they took out tracker mortgages on the understanding that their rates would only move in line with the base rate. In a recent "Dear CEO" letter to lenders, the FCA indicated that such amendments

to mortgage contracts could breach both consumer protection laws and the FCA's Principles for Businesses. The discussion paper is intended to open up debate on the topic within the industry.

UK: Policy and Practice

Martin Wheatley highlights areas of FCA focus for 2014: 9 December 2013

FCA Chief Executive Martin Wheatley used a recent speech to the ICI Global Trading and Market Structure Conference to outline some of the key themes for the FCA in the year to come. He stated that 2014 will involve a cultural shift towards a "more mature age" in which investor interests become central to a firm's business model. The FCA will move towards assessing the 'integrity' of both firms and individuals in terms of "the ethics of care and reason" rather than the "ethics of obedience" (that is, what is legally right or wrong). The FCA will also continue to use a broader range of judgement-based tools, including behavioural economics and sophisticated modelling, to "get under the bonnet" of the financial services industry. Sources of firm revenue will also be investigated. Mr Wheatley made some specific comments about the asset management sector, which has recently been the subject of considerable supervisory and enforcement action. Key issues for the industry were said to include a lack of accountability in spending commissions charged to customers and the question of whether the desire to secure corporate access is creating conflicts of interest within asset managers.

From an enforcement perspective, the comments about firms' culture and senior management engagement are instructive. The FCA is continuing to focus specifically on the activities of senior managers, employing techniques such as requiring attestations to secure their engagement and focusing upon individuals' behaviour when taking enforcement action against firms. The FCA's supervision team appear to be taking a deliberate decision to move away from monitoring adherence to rules, which are viewed as potentially removing responsibility from individuals for deciding what the correct course of action may be in any particular situation. In future it seems likely that the actions of firms and their senior managers will be judged in accordance with more ill-defined concepts such as consumers' 'best interests' (as judged by the regulator) rather than by their compliance with existing rules and guidance.

UK: Recent Decisions

Upper Tribunal bans former trader following conduct during Tribunal hearing: 13 December 2013

The Upper Tribunal has imposed a prohibition order on former Mizuho trader David Hobbs having found that he had lied both to the Tribunal and the FCA during a market abuse investigation. The FCA issued a decision notice in 2010 indicating that they were minded to impose a fine of £175,000 and ban Mr Hobbs for market abuse in respect of trading in coffee futures he

conducted on the Euronext LIFFE exchange in August 2007. Mr Hobbs referred this decision to the Upper Tribunal, where it was overturned (see further the December 2012 edition of this Update). The FCA proceeded to appeal the Tribunal's findings on fitness and propriety (but not market abuse) to the Court of Appeal. The Court agreed that the Upper Tribunal was required to address the question of whether Mr Hobbs remained a fit and proper person in the light of its finding that he had lied whilst giving evidence.

The Tribunal concluded that Mr Hobbs's conduct in putting forward a false defence during the FCA's investigation and maintaining this when giving evidence demonstrated a lack of integrity such that he could no longer be considered a fit and proper person. It was particularly concerned that Mr Hobbs had failed to acknowledge any wrong doing in respect of his, now discredited, defence. Although Mr Hobbs maintained that he had not worked in the financial services sector since 2007 and had no intention of returning to it, the Tribunal concluded that the imposition of a prohibition order was both appropriate and proportionate. It considered that such an order would provide a mechanism for enabling the FCA to assess whether to allow him to return to financial services work, should he elect to do so in future (applications to vary or revoke such orders can be made to the FCA under s.56(7) FSMA). Although the facts of this case are unusual, it is submitted that in pursuing action against individuals in respect of evidence given in their defence, the FCA needs to strike a careful balance between deterring dishonestly in the guilty and not stifling the ability of the innocent to contest their case.

Former Finance Director fined for failings during 2008 financial crisis: 11 December 2013

The former Group Finance Director of the Bradford & Bingley plc (the "Bank") has been fined £30,000 for breaches of APER 6 (due skill, care and diligence) said to have occurred over a period of four days, when the bank was pursuing a rights issue that it had announced on 14 May 2008. The FCA found that Mr Willford should have escalated to the Board on Friday 16 May information indicating a potential worsening of the Bank's financial position, ahead of the issuance of the rights issue circular on 19 May 2008. This information was in fact escalated and considered by the Board on Tuesday 20 May 2008.

The failings were regarded as serious as Mr Willford held a senior position at a large retail bank and was an experienced finance professional. In addition, given the difficult market conditions and press speculation about the Bank's financial position, it was vital that Mr Willford ensured that the Board was correctly advised. In setting the level of the financial penalty, the final notice indicates that the FCA has taken into account the fact that the breaches occurred over a period of only four days at the height of the financial crisis, at a time when Mr Willford was under considerable pressure and when his workload had significantly increased (in part due to the ill-health of the Bank's CEO). In addition, it was noted that other senior individuals reviewed the same financial information and formed the same view as Mr Willford. His actions were not found to have contributed to the trading update (which amounted to a profits warning) issued by the Bank in early June 2008, nor did

they contribute to the subsequent failure of the rights issue and recapitalisation of the Bank. Mr Willford had previously brought a judicial review action challenging the FCA's decision notice in his case (see our briefing note on the decision here). At the time of the decision notice, the penalty the FCA was imposing was £100,000, reduced from the £150,000 initially proposed in the warning notice. The final notice reduces the penalty still further to £30,000.

Although the final notice acknowledges the extreme circumstances in which the breaches were said to have occurred, the decision is nevertheless a clear indicator of the high standard against which senior managers will be judged by the FCA's enforcement division, particularly when the conduct is connected to a high profile crisis. There is, however, a real question as to whether a Tribunal would apply the same standard when assessing the reasonableness or otherwise of a senior manager's conduct. The John Pottage decision is a prominent indicator of the more measured approach the Tribunal takes to such issues.

Banking Group fined for failing to control sales incentive schemes: 10 December 2013

Lloyds TSB Bank plc and Bank of Scotland plc (together, the "Firms") have been fined £28,038,800 for serious failings in their controls over sales incentive schemes which occurred between January 2010 and March 2012. The fine is the largest imposed by the FCA to date for retail conduct failings. Following a thematic review of sales incentives (the results of which were published in September 2012) the FCA uncovered evidence that incentives schemes employed by the Firms involved a number of high risk features, which the various controls in place were insufficient to mitigate. These included variable salaries, bonus thresholds, one-off payments and prizes and explicit encouragement to sell protection products, which were a strategic focus for the Firms. In addition, advisers could be automatically promoted or receive a pay increase, or be automatically demoted or receive a pay decrease, depending on their sales performance. The Firms have agreed to review sales made by higher-risk advisers and to pay redress where unsuitable sales have taken place. The FCA acknowledges in the final notice that, due to increases in the value of the stock market since 2010, actual customer detriment from any unsuitable sales of investment products may be low.

The FCA considered the Firms' failings to be particularly serious given their position in the retail banking market and the fact that they failed to identify the risks changes to their incentive schemes posed to consumers' interests. The FCA also highlighted the fact that both it and its predecessor have, for many years, warned firms of the risks posed to consumers by financial incentive schemes, culminating in final guidance detailing good and bad practice in this area which was published in January 2013. Senior management was also criticised for failing to identify incentives schemes as a key area of risk requiring robust oversight. In employing its five-step framework to calculate the fine, the FCA considered the Firms' previous disciplinary record, in

particular the fact that Lloyds TSB Bank plc was fined £1.9m for its conduct in selling high-income bonds in 2003, which involved a finding that sales advisers had been put under pressure to meet sales targets. As a result the FCA increased the step two figure by 10%. The Firms also received a 20% discount for early settlement. The FCA considers that financial incentives schemes are an important indicator of a firm's values and priorities. Given the importance the regulator now attaches to culture in ensuring that firms put the interests of consumers at the heart of their business, it is vital that such schemes are designed with consumers, rather than simply profit, in mind.

Financial adviser banned for advising investor to engage in market abuse: 13 November 2013

The FCA has banned a financial adviser who encouraged an investor client to engage in conduct which, had the adviser engaged in it, would have amounted to market abuse. Rahul Shah was retained as an independent consultant for an investor (termed "Investor A" in the final notice) between 2009 and 2011. His role was to find investment opportunities for Investor A and he received a share of any profits generated as a result of his suggestions. On 16 June 2010 Mr Shah was invited to become an insider in respect of Vyke Communications plc ("Vyke"), which was about to announce its entry into a joint venture agreement with a US telecommunications company. On 30 June 2010 Mr Shah was informed that the announcement of the joint venture was imminent. The price of shares in Vyke had fallen and it was commented that this was a good opportunity to buy shares for those not on the "inside". Mr Shah immediately spoke to Investor A, suggesting that the adviser for Vyke had told him that it was a good time to buy. Investor A subsequently placed two orders for Vyke shares. It is not suggested that Investor A was in receipt of inside information at any point, nor did he know that Mr Shah was aware of the proposed joint venture. Once Investor A became aware that Mr Shah possessed inside information he refused to sell the shares he had purchased. Vyke subsequently went into administration and the shares became worthless.

In terms of the penalty, the FCA chose the version of its new fining policy designed for individuals involved in market abuse cases, rather than the framework for non-market abuse cases which has been used in other cases in which the FCA has taken action against individuals for failing to act to prevent market abuse. This served to increase the fine the FCA would have imposed (along with the prohibition order) had Mr Shah not provided verifiable evidence that this would cause him financial hardship, as the framework for market abuse fines employs as its starting point a minimum penalty of £100,000.

The decision is the latest in a number recently taken by the FCA in respect of approved persons and others who facilitate, or fail to prevent, market abuse by others. In this case the FCA highlighted the fact that Mr Shah was an experienced industry professional and a former approved person. He had also received a policing letter from the Markets Division in respect of earlier behaviour which could have been regarded as market abuse. The regulator is

clear that it expects such individuals to act as "gatekeepers", protecting the front-line of the industry against abusive behaviour.

Asset management firm fined for client money failings: 25 November 2013

SEI Investments (Europe) Limited ("SEI") has become the second asset management firm in as many months to be fined for client money failings. The FCA has fined the firm £900,200 for breaches of Principle 10 (client money) and various rules in Chapter 7 of the Client Assets Sourcebook. The firm received a 30% discount for early settlement, without which the fine would have been £1,286,000. The relevant breaches occurred over a period of five years between November 2007 and October 2012. They included failures to perform internal client money reconciliations and to ensure that any shortfall or excess was paid into or withdrawn from the client bank account by close of business on the day of reconciliation; a failure to appreciate that the firm was using a non-standard method of internal client money reconciliation; failures to make the appropriate notifications or to submit Client Money Asset Returns; and inadequate training of employees with key responsibility for client money. The failings are identified as taking place during a period of rapid expansion by SEI, suggesting that insufficient attention was given to the need to ensure that the firm's systems kept pace with developments in the business. Where this is the case, the risk of enforcement action for regulatory breaches is high, as recent decisions against firms such as Mitsui Sumitomo Insurance Company (Europe) Ltd and Martin Currie Investment Management Ltd demonstrate. The FCA also noted that the breaches were not identified by SEI through its own compliance monitoring and occurred during a period of hightened awareness of the importance of strict adherence to the client money rules. The firm had also confirmed (incorrectly, in the FCA's view) that it was in compliance with its client money obligations (subject to some qualifications) in response to a "Dear CEO" letter concerning client money issued by the FSA in January 2010.

As with the final notice in respect of Aberdeen Asset Managers Limited and Aberdeen Fund Management Limited last month, given the period of the relevant breaches the FCA has employed both its old and new policies in calculating the penalty imposed upon SEI. As regards the new policy, the FCA continues to utilise the average client money balances held by the firm over the relevant period as the starting point for its calculation of the penalty, with a percentage figure being applied to that average balance to reflect the seriousness of the breach. This decision is further evidence of the FCA's focus on the firms in the asset management sector. It also demonstrates the FCA's increasing lack of patience, given the attention it has given to this issue, with organisations whose client money systems are judged to be inadequate.

EU: Policy and Practice

ESMA publishes discussion paper on implementing measures under the Market Abuse Regulation: 14 November 2013

The European Securities and Markets Authority (“ESMA”) has published a discussion paper on possible implementing measures under the Market Abuse Regulation. The paper outlines ESMA’s proposed approach to drafting technical standards and advice to the European Commission on delegated acts and will be followed by a full consultation and final draft of each of these documents in early 2014. The paper considers the likely approach to the new market sounding exemption, including information on the respective roles of the sell-side and the buy-side in conducting a market sounding that falls within the new exemption in MAR.

ESMA will consider all comments received by 27 January 2014

Linklaters has updated its Fact Sheet on the revision of the Market Abuse Directive to take into account this latest development. This appears on Linklaters Knowledge Portal, a one stop shop to all our publications which is restricted to our clients. If you are not yet a subscriber, please sign up now.

ESMA and EBA issue consultation on complaints-handling guidelines: 6 November 2013

A joint consultation paper containing draft guidelines for complaints handling in the banking and securities sector has been issued by ESMA and the European Banking Authority (“EBA”). The consultation paper seeks comments on seven draft guidelines on complaints handling including complaints management policy and function, registration and reporting, internal follow-up, the provision of information and the procedure for responding to complaints. The draft guidelines are intended to clarify expectations in respect of firms’ systems and controls for complaints handling, provide a minimum level of supervisory convergence across the EU and protect consumers by harmonising firms’ complaints-handling arrangements.

The deadline for responses to the consultation is 7 February 2014. ESMA and the EBA intend to publish their final report and guidelines in the first quarter of 2014. It is expected that these will then be incorporated in the supervisory practices of competent authorities across the EU, including the FCA, providing a further example of EU regulatory “creep” in respect of national regulatory regimes.

Hong Kong: News

Court makes first restoration orders in insider dealing case to compensate trade counterparties

On 12 December 2013, the Court of First Instance ordered a former managing director of a global investment bank to pay $23.9 million to investors, following his conviction in 2009 for insider dealing in shares of CITIC Resources Holdings Limited ("CITIC Resources").This is the first time a restoration order to return money to investors has been made by the court under section 213 of the Securities and Futures Ordinance in an insider dealing case. Commenting on the order, Mark Steward, the Securities and Futures Commission’s ("SFC") Executive Director of Enforcement said that it

"sends a clear message that the consequences of wrongdoing, including the costs of restoration or remediation, should be met by wrongdoers and not be borne by innocent investors or the market".

The payment to be made under the restoration orders will be calculated as the difference between the actual price at which the affected investors sold the CITIC Resources shares to the former banker, and the price at which they could have sold the shares had the price sensitive information concerning CITIC Resources been disclosed to the market at the time. The orders mark the end of the civil proceedings initiated by the SFC against the former banker.

U.S.: News

U.S. State Department extends Iran sanctions exceptions under the NDAA

On November 29, 2013, the U.S. State Department extended six-month Iran sanctions exceptions for nine countries, in exchange for their reduced purchases of Iranian crude oil earlier this year. Under Section 1245 of the National Defense Authorization Act of 2012, banks in these countries — China, India, Malaysia, South Africa, South Korea, Singapore, Sri Lanka, Taiwan, and Turkey — are permitted to engage in transactions that would otherwise have subjected them to sanctions under the NDAA.

The sanctions exception is a product of Section 1245 of the NDAA, which, among other things, makes it sanctionable for foreign financial institutions to conduct or facilitate a significant financial transaction with the Central Bank of Iran or any other designated Iranian financial institution that relates to the purchase of petroleum or petroleum-related products from Iran. The exception provides an exemption from such sanctions in cases where the U.S. Secretary of State determines and reports to Congress that the country with primary jurisdiction over the foreign financial institution has significantly reduced its volume of crude oil purchases from Iran. Exceptions under the NDAA run for periods of 180 days; in order for a country to receive a renewal of the exception for an additional 180 day period, the NDAA requires that the Secretary of State determine that the country at issue significantly reduced its volume of crude oil purchases from Iran during the 180 day period.

Meanwhile, on November 24, Iran agreed to a six-month freeze of its nuclear program, creating a window to negotiate a solution to the ongoing nuclear dispute between Iran and a number of Western powers. The U.S. sanctions regulations vis-a-vis Iran are in a particularly tumultuous state, with several U.S. lawmakers are discussing new sanctions as “insurance” against potentially-failed negotiations.

The November 29 Announcement can be found here.

U.S. Regulators Adopt Volcker Rule

On December 10, 2013, U.S. regulators issued a rule implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of

2010 (12 U.S.C. § 1851), commonly known as the “Volcker Rule.” The Rule prohibits a federally insured depository institution, U.S. bank holding company, non-U.S. bank with a U.S. branch or agency, and any affiliate of the foregoing from (1) engaging in proprietary trading, (2) acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund, and (3) sponsoring a hedge fund or a private equity fund. The Rule permits trades that hedge “specific and identifiable” risks, prohibiting general-purpose hedges not attached to a specific position or aggregation of positions. However, non-U.S. banks, unlike their American equivalents, will be allowed to continue proprietary trading outside the United States, and in doing so may, in certain circumstances, transact with U.S. counterparties and utilize U.S. exchanges and other market infrastructures. The final Rule also exempts non-public funds that are sponsored by foreign banks, so long as they are not offered to U.S. investors. The Federal Reserve already has extended banks’ compliance deadline to July 2015, but could grant up to two additional one-year extensions for a final deadline of July 2017.

Author: Sara Cody

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Contacts

For further information please contact:

James Gardner
Partner

(+44) 207 456 4357

james.gardner@linklaters.com

Patrick Robinson
Partner

(+44) 207 456 5879

patrick.robinson@linklaters.com

Christa Band
Partner

(+44) 207 456 5626

christa.band@linklaters.com

Martyn Hopper
Partner

(+44) 207 456 5126

martyn.hopper@linklaters.com

Nikunj Kiri
Partner

(+44) 207 456 3256

nikunj.kiri@linklaters.com

Lance Croffoot-Suede
Partner

(+1) 212 903 9261

lance.croffoot-suede@linklaters.com

One Silk Street
London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com