



Banking Industry Regulatory Update

September 2012

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The business of relationships.

Banking Industry Regulatory Update

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1. INTRODUCTION

International regulatory bodies, working alongside their regional and national counterparts, have spent over four years attempting to mend the global financial system by strengthening its stability and resilience. In 2012, the stream of regulations does not appear to be slowing, as governments and regulators continue to address the issues arising from the financial crisis.

This banking industry regulatory update, the seventh in the series, sets out the key banking industry reforms, and proposals for reform, in the international, European and UK spheres. This update sets out the position as at September 2012. It should be noted that, as this is an ever changing regulatory landscape, care should be taken when reading the update as it will become out of date relatively quickly.

2. BANKING SUPERVISION – REVIEW OF THE CORE PRINCIPLES

In its October 2010 [Report to the G20](#), the Basel Committee on Banking Supervision (the “**BCBS**”) announced its plan to review the Core Principles for Effective Banking Supervision (the “**Core Principles**”), which were last updated in 2006. On 20 December 2011, the BCBS published a [consultation document \(BCBS213\)](#) on the review.

The Core Principles are a framework of universally applicable minimum standards for sound prudential regulation and supervision of banks and banking systems. They are used by countries as a benchmark for assessing the quality of their supervisory systems, and by the International Monetary Fund (“**IMF**”) and World Bank in the context of the Financial Sector Assessment Programme.

Following the [consultation \(BCBS213\)](#) in December 2011, the BCBS has published a revised [Core Principles](#). The new principles combine the 2006 versions into a single comprehensive document. The key changes to the Core Principles include the following:

- a new Core Principle on corporate governance has been added by bringing together existing corporate governance criteria in the assessment methodology and giving greater emphasis to sound corporate governance practices. The BCBS has also expanded an existing core principle into two new ones relating to public disclosure and transparency, and enhanced financial reporting and external audit;
- the number of Core Principles has increased from 25 to 29;
- There are 39 new assessment criteria, comprising 34 new essential criteria and 5 new additional criteria; and
- 34 additional criteria from the existing assessment methodology have been upgraded to essential criteria that represent minimum baseline requirements for all countries.

The BCBS has reorganised the principles to highlight the difference between what supervisors do and what they expect banks to do:

- principles 1 – 13 address supervisory powers, responsibilities and functions, focusing on effective risk-based supervision and the need for early intervention and timely supervisory actions; and

- principles 14 – 29 cover supervisory expectations on banks, emphasising the importance of good corporate governance and risk management, as well as compliance with supervisory standards.

3. CORPORATE GOVERNANCE

(a) International – BCBS

On the international stage, there has been a continued emphasis on effective governance. This focus stems from the view that corporate governance is so fundamental to both individual banking organisations and to the international financial system as a whole, it merits targeted supervisory guidance. The BCBS published a set of 14 principles (the “Principles”) for enhancing sound corporate governance practices in October 2010, following its consultation on those principles in March 2010.

As outlined in our previous updates, the focus of the Principles is primarily on attributing responsibility for corporate governance, risk management/strategy and corporate values to the board and senior management (rather than to regulatory supervisors). Emphasis is also placed on the need for the board to ensure effective communication laterally and vertically (in order for risk and other issues to be adequately dealt with) and for each board member to properly know and understand the institution’s structure. The sentiment that a board must establish and promote corporate values that discourage excessive risk taking pervades the Principles.

Specifically, the Principles include the following requirements:

- appropriate practices, committees and roles must be set up to manage risk, remuneration, conflicts and auditing. Such practices must keep pace with the bank’s sophistication and risk profile;
- the board of a parent company must take responsibility for overseeing corporate governance across the group;
- the board must properly understand the bank’s corporate structure and the nature and purpose of any offshore or unregulated entities;
- communication lines must be adequate to effectively report risk issues and exposures to the board;
- compensation must be aligned with prudent risk taking;
- a bank’s code of conduct must outline acceptable and unacceptable risk taking behaviour and that the board should take the lead in establishing the correct ‘tone at the top’.

The BCBS advises supervisors to establish guidance or rules in accordance with the Principles. The BCBS notes that banks’ compliance with the Principles (as implemented by the bank’s home country) should be proportionate to the size, complexity, structure, economic significance and risk profile of a bank, and the corporate group it belongs to (if relevant).

In June 2011, the BCBS updated a framework of principles concerning operational risk management for banks and their supervisors published in 2003 called **Sound Practices for the Management and Supervision of Operational Risk (Sound Practices)**, to reflect current industry practice. The framework of principles incorporates governance as an over-arching theme and, in line with the BCBS’s 14

Principles, places emphasis on the role of the board of directors in assessing operational risk and overseeing the implementation of appropriate policies and procedures.

Building on the 14 Principles, the BCBS issued supervisory guidance on the internal audit function in banks (BCBS223) on 28 June 2012. The guidance revises the previous supervisory guidance issued in August 2001 whilst taking account lessons learnt from the financial crisis and evolutions in the sector. The guidance consists of 20 principles relating to:

- supervisory expectations relevant to the internal audit function;
- the relationship between supervisors and the internal audit function; and
- supervisory assessment of banks' internal audit function.

The BCBS expects to publish a consultative version of its external audit guidance in late 2012. This was announced in the [press release](#) that was published with BCBS210 in December 2011. This new guidance will be additional to the previous BCBS guidance ([BCBS87](#) and [BCBS146](#))

(b) Europe

At European level, the European Commission (the “**EC**”) published a [Green Paper](#) on corporate governance in June 2010, which discussed the links between corporate governance and the financial crisis; and suggested options for reform along similar lines to the Principles. On 12 November 2010, the EC published a feedback statement on responses to its green paper which had been given by interested parties such as the FSA. While the feedback statement demonstrates the broad support of the industry to the EC’s proposals (particularly in relation to the clarification of responsibility), it also noted that many respondents see corporate governance failures as due to a lack of effective implementation of existing rules rather than deficiencies in the regulatory regime.

The European Parliament adopted a resolution in response to the Green Paper on 11 May 2011, in which it:

- emphasised the need for financial institutions to establish effective governance systems, with adequate risk management, compliance, internal audit functions, strategies, policies, processes and procedures;
- called for the establishment of mandatory risk committees or equivalent arrangements at board level for all economically significant financial institutions;
- called for the establishment of “fit and proper persons” criteria to be implemented by national regulators;
- called on the EC to develop legislation requiring large financial institutions to submit their boards to regular external evaluation;
- encouraged institutional shareholders to take a more active role in holding the board to account with a view to encouraging a culture of greater responsibility.

On 5 April 2011, the EC published another [Green Paper](#) as part of a public consultation focused on improving the corporate governance of European companies. The Green Paper was intended to prompt debate in three key areas: the functioning of boards of directors; how to enhance shareholder involvement and how to improve the effectiveness of the existing national corporate governance codes. The EC published a [feedback statement](#) on the responses to the Green Paper on 15 November 2011.

In addition, the European Banking Authority (the “EBA”) published a set of **Guidelines on Internal Governance** (the “Guidelines”) on 27 September 2011, following a consultation on a draft version of the Guidelines in October 2010. The Guidelines seek to improve the implementation of internal governance arrangements in credit institutions and apply on a “comply or explain” basis. The Guidelines update and consolidate the former Committee of European Banking Supervisors (the “CEBS”) guidelines, including the CEBS High Level Principles on Remuneration and on Risk Management. They contain new guidance on:

- the transparency of corporate structures, with the introduction of the “know-your-structure” principle;
- the composition, appointment and succession and qualifications of the management body;
- the responsibilities of the management body regarding outsourcing and setting the remunerations policy;
- the role of the Chief Compliance Officer and the risk management function; and
- information and communication systems and business continuity management.

National authorities must implement the guidelines by 31 March 2012. They were required to notify the EBA as to whether they comply or intend to comply with the Guidelines (or their reasons for non-compliance) by 28 November 2011.

CEBS was replaced by the new, more powerful EBA as of 1 January 2011 which exercises a wider role than its predecessor. For example, the EBA is able to issue binding technical standards on member states and has indicated that it is keen to press for a single EU rule book. The EBA was also responsible for EU-wide bank stress testing in 2011.

(c) United Kingdom

In the UK, the government and the Financial Services Authority (the “FSA”) have been responsible for a number of initiatives to strengthen corporate governance in financial services companies. These include the implementation of the **Walker Review** of 2009 (which set out 39 recommendations which are intended to improve the governance of UK banks and other financial institutions), through revised governance and remuneration codes, a new stewardship code, and increased supervision of individuals performing significant influence functions in regulated firms.

The Walker Review was considered by the Financial Reporting Council (the “FRC”) in early 2010. The primary conclusions drawn by the FRC can be summarised that; more attention should be paid to following the spirit of the existing Combined Code on Corporate Governance 2008 (the “**Combined Code**”) as well as its letter and that the impact of shareholders in monitoring the Combined Code could be enhanced by better interaction between the boards and their shareholders. The FRC review thus led to the Combined Code being replaced by:

- the **UK Corporate Governance Code 2010** (the “**Code**”) which applies to listed companies (including financial institutions) for reporting periods beginning on or after 29 June 2010; and
- the **UK Stewardship Code 2010** (the “**Stewardship Code**”) which sits alongside and is complimentary to the Code, and which will apply to fund managers and other institutions authorised to manage assets on a discretionary basis for “professional clients” (including collective investment schemes, insurance companies and pension funds).

Both codes apply (as the Combined Code did) on a ‘comply or explain’ basis.

In December 2011, the FRC announced that it would consult on changes to both the Code and the Stewardship Code. Subsequently, in April 2012, the FRC published a **consultation** in relation to proposed changes to the Code. The changes include:-

- FTSE 350 companies put the external audit contract out to tender at least every ten years.
- Boards to explain why they believe that their annual reports are fair and balanced.
- More meaningful reporting by audit committees.
- When failing to comply with the Code, a company should provide greater explanations to shareholders.

The deadline for responding was the 13 July 2012 and, subject to the outcome, the proposed changes will enter into force for financial years commencing on or after 1 October 2012.

In relation to the Stewardship Code, the FRC also published a **consultation** in April 2012. The proposed changes relate to the meaning of “stewardship”, the respective roles and responsibilities of asset owners and asset managers, disclosure of the investors policy on stock lending (and whether the lent stock is recalled for voting purposes) and updates reflecting current market practice.

The deadline for responding was 13 July 2012 and, subject to the outcome, the proposed changes will enter into force for financial years commencing on or after 1 October 2012.

(i) The Code

The Code consists of main and supporting principles spanning the five areas of leadership, effectiveness, accountability, remuneration and relations with shareholders. However, the Code differs in tone from the Combined Code in that it places more importance on the main principles which should guide board behaviour and which should be continually considered and reported on by the board. These are now listed separately at the front of the Code (in addition to later on together with the supporting principles). The primary differences between the Code and the Combined Code include:

- increased emphasis on the roles and responsibilities of the Chairman, the senior independent director and non executive directors (the “**NEDs**”);
- requirement that any search for board candidates should have regard to diversity, including gender diversity;
- requirement for directors of FTSE 350 companies to be subject to annual re-election;
- requirement that external board evaluation reviews be conducted every 3 years by FTSE 350 companies;
- emphasis on directors’ time commitments;
- emphasis on consideration and management of risk; and
- amendments to provisions related to performance related remuneration.

(ii) The Stewardship Code

Broadly, the Stewardship Code sets out good practice for institutional investors when engaging with UK listed companies. The seven principles of the Stewardship Code cover the establishment and, where required, disclosure of practices relating to collective action with other investors, monitoring investee companies, voting policy and disclosure, enhancing shareholder value and the management

of conflicts of interest. Adherence to the Stewardship Code is not compulsory (it applies on a “comply or explain” basis), however, the FSA rule in COBS 2.2 makes disclosure of a regulated firm's commitment to the code (or lack of) mandatory. The alternative to compliance is to explain why the firm's alternative business model makes compliance inappropriate. While certain of the requirements will already be part of a firms' practice, the net effect of compliance with the Stewardship Code is that a regulated firm must make public arrangements and policies that previously remained confidential.

The British Bankers' Association (“**BBA**”) published a response to the Department for Business, Innovation and Skills’ (“**BIS**”) call for evidence “**A Long-Term Focus for Corporate Britain**” in January 2011, which states that it views the Stewardship Code as a step in the right direction and is supportive of the FRC in its endeavours to promote it. The call for evidence, published on 25 October 2010, was the first stage of a review into corporate governance and economic/board ‘short-termism’ in capital markets. BIS published the outcome of the consultation on 28 March 2011. Shortly afterwards, on 22 June 2011, the BIS announced that Professor John Kay was to carry out an independent review into investment in UK equity markets and its impact of the long-term competitive performance and governance of UK quoted companies (further discussed below).

(iii) Review of the Code and the Stewardship Code

On 14 December 2011, the FRC **published** the first of what is intended to be an annual series of reports on the impact and implementation of the Code and the Stewardship Code. The report revealed that there had been a high level of compliance with the Code, with, for example, 80 per cent of FTSE 350 companies already adopting annual re-election of all directors. The report also reveals a positive response to the Stewardship Code, with over 230 asset managers, asset owners and service providers signing up since its introduction in June 2010. The FRC consulted on limited revisions to both the Code and the Stewardship Code during early 2012 and subsequently published the two aforementioned consultation documents (**Revisions to the UK Stewardship Code** and **Revisions to the UK Corporate Governance Code and Guidance on Audit Committees**).

As mentioned above, the deadline for responding was the 13 July 2012 and, subject to the outcome, the proposed changes will enter into force for financial years commencing on or after 1 October 2012.

In addition, on 5 May 2011, the FRC published a consultation paper on Gender diversity on boards. In a feedback statement dated 11 October 2011, the FRC has announced, that as of 1 October 2012, companies governed by the Code will have to report annually on their boardroom diversity policy (including measurable objectives set to implement the policy and the progress made) and consider the diversity of the board when evaluating board effectiveness.

(iv) Kay Review

In 2011, BIS commissioned an independent review of the effect of UK equity markets on the competitiveness of UK businesses (the “**Kay Review**”). Professor John Kay, who chairs the review, launched a call for evidence on 15 September 2011. His speech emphasised that the subject of the review was corporate decision making and performance rather than corporate governance.

On 23 July 2012, Professor Kay published his **final report** on the review of UK equity markets and long-term decision making. The Kay Review concludes that, overall, short-termism is a problem in the UK equity markets. The recommendations are that there should be a shift in the culture of the stock

market, relationships should be restored on trust and confidence, and incentives realigned across the investment chain.

(v) *Approved Persons*

The FSA confirmed in its Business Plan for 2011/12 that corporate governance remains a key area of focus in the coming months. The publication of the **policy statement PS10/15** on effective corporate governance in September 2010 highlighted the extent of the work being done in relation to significant influence and controlled functions.

Under PS10/15 and the corresponding amendments to the FSA handbook:

- a new framework of classification of controlled functions is being created including: parent entity SIF (CF00), chairman (CF2a), senior independent director (CF2b), chairman of risk committee (CF2c), chairman of audit committee (CF2d) and chairman of remuneration committee (CF2e);
- three new systems and controls functions are being introduced: finance function (CF13), risk function (CF14) and internal audit function (CF15). The current systems and controls function (CF28) will be deleted; and
- the scope and definition of the already existing director (CF1) and non-executive director (CF2) controlled functions are being reduced.

These amendments were due to come into force on 1 May 2011. However, in March 2011, the FSA announced that implementation would be postponed until a later date.

- Guidance is provided on the role to be played and time commitments to be made by NEDs, while guidance on the limits of liability of NEDs in SYSC 2.1.2G and 4.4.4G is to be deleted.

This part of the new regime came into force on 1 May 2011.

4. REMUNERATION

(a) International

As mentioned in our February 2012 update, the Financial Stability Board (“FSB”) completed its **first peer review on compensation** in March 2010, concluding that key issues were yet to be resolved and effective implementation was far from complete. A second peer review, the **Thematic Review on Compensation**, was published on 7 October 2011. In June 2012, the FSB published a further **report** on the progress made by member jurisdictions and firms implementing the FSB’s compensation principles and implementation standards which covers the period from October 2011. The main findings of the report include the following:

- almost all FSB member jurisdictions have now implemented the principles and standards;
- notable progress has been made on the implementation of the Basel Committee on Banking Supervision’s Pillar 3 disclosure requirements for remuneration, but more needs to be done to fully embed them in regulatory or supervisory guidance across all jurisdictions;

- there continues to remain important differences across jurisdictions in terms of applying the principles and standards, particularly in the use of proportionality and the identification of firm's employees as material risk takers; and
- supervisory attention to compensation issues continues to increase and is contributing to sounder compensation structures at firms. Supervisory co-operation in respect of cross-border financial institutions is also improving.

Further in July 2012, the FSB published a [table](#) setting out member jurisdictions' legal requirements on compensation.

(b) Europe

The European Commission has outlined its intention to replace and recast the Capital Requirements Directive (2006/48/EC and 2006/49/EC) ("**CRD3**") with the new Capital Requirements Directive ("**CRD4**") which is to come into force by 1 January 2013. With respect to remuneration, the bulk of the material in CRD3 will continue to apply to the CRD4 regime. However, the Commission has increased firms' disclosure requirements, and under the CRD4, firms are required to disclose "the number of individuals being remunerated EUR1 million or more per financial year, broken down into pay bands of EUR500 000".

Further, as outlined in the February 2012 update the current regime requires that an institution's policies include caps on cash bonuses, bonus deferrals and new bonus/salary ratios, the recurring aims being to better align remuneration with the long term interests of the institution. It is also intended that the amendments will bring down the disproportionate role played by bonuses in the financial sector. This has been implemented in the UK through amendments to the UK's remuneration code (see below). The CEBS [Guidelines on Remuneration Policies and Practices](#), which address high-level remuneration policies and the day-to-day practice of making remuneration decisions, continue to be relevant.

In accordance with the proposals outlined in the EC's Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies published on 2 June 2010, the recently adopted and published Alternative Investment Fund Managers Directive, amendments to the UCITS IV Directive (2009/65/EC) (UCITS IV) and the Solvency II Directive (2009/138/EC) contain provisions on the remuneration in the investment fund and insurance context.

(c) United Kingdom

As mentioned in the February 2012 update, the FSA revised its remuneration code in December 2010. The revised remuneration code (the "**Remuneration Code**") and disclosure requirements have been inserted into the FSA handbook by the Senior Management Arrangements, Systems and Controls (Remuneration Code) (No 2) Instrument 2010 and Prudential Sourcebook for Banks, Building Societies and Investment Firms (Remuneration Disclosures) Instrument 2010.

The rules on disclosure require a firm to disclose, on an annual basis, its remuneration policy and details in respect of senior management and members of staff whose actions have a material impact on the risk profile of the firm. The disclosure may form part of the firm's annual report and accounts provided the disclosure meets the relevant requirements. The FSA has recently published a

consultation paper (CP12/18) on data collection regarding remuneration practices. The FSA has proposed two types of reports that relevant firms will be required to file:

- (i) Remuneration Benchmarking Information Report – data on the remuneration of employees by significant firms (firms that either represent 60% or more of the total banking and investment services sector of the Member State concerned, or the 20 largest institutions in the banking and investment services sector of the Member State concerned) and their subsidiaries and branches; and
- (ii) High Earners Report – data on firms employees with total annual remuneration of EUR1 million or more.

The changes will be incorporated by introducing new rules in SUP 16 in the FSA Handbook. With regards to both reports above, a firm that is within the scope of the report(s) on the date the rules come in to effect will be required to submit two reports by 31 December 2012 (one for each of the previous 2 completed financial years), and thereafter a report annually within two months after the firms accounting reference date.

The FSA is still currently in the consultation phase which is due to close on 30 September 2012. The FSA is hoping to publish a Policy Statement by the end of October 2012 with the Handbook rules coming in to effect by 1 November 2012.

(i) Proportionality

In September 2012 the FSA published finalised guidance on proportionality, specifically relating to the Remuneration Code (found in SYSC 19A) and Pillar 3 disclosures on remuneration (found in BIPRU 11). The FSA has replaced the current four-tier division of remuneration code firms, with three new levels based on total assets. The new approach is intended to allow the FSA to focus its resources on the most significant firms who pose risks to financial stability. The new structure is as follows:

- proportionality level one - banks and building societies with regulatory capital exceeding £50bn and BIPRU 730k firms that are full scope BIPRU firms with capital resources exceeding £50bn;
- proportionality level two – banks and building societies with regulatory capital exceeding £15bn but not £50bn and BIPRU 730k firms that are full scope BIPRU firms with capital resources exceeding £15bn but not £50bn; and
- proportionality level three - Banks and building societies with regulatory capital not exceeding £15bn and any full scope BIPRU investment firm that does not fall within proportionality levels one or two, any BIPRU limited license firm and any BIPRU limited activity firm.

With regards to proportionality levels one and two, a remuneration committee is required. However with regards to proportionality level three the FSA has stated that although it is desirable a remuneration committee to be established, it accepts that it may be appropriate for the governing body of the firm to act as the remuneration committee.

Further if firms to which the Remuneration Code applies are part of a group, all firms within that group will fall into the highest proportionality level that any individual firm falls in to.

It is clear that the new approach will allow the FSA to focus its attention on firms which require closer supervision. However, as outlined in the February 2012 update, organisations will need to be

prepared for a much closer relationship between their HR and compliance functions when it comes to pay, which will again, demand greater organisation.

5. FINANCIAL TRANSACTIONS TAX

On 7 October 2010, the EC issued a Communication called Taxation of the Financial Sector together with a staff working document, press release and set of questions and answers on the topic. The Communication put forward a two pronged approach, based on the premise that “the financial sector needs to make a fair contribution to public finances, and that governments urgently need new sources of revenue,” which includes both a financial transactions tax (“**FTT**”), which the EC believes should be implemented at a global level, and a financial activities tax (“**FAT**”) (to be imposed on financial institutions) to be introduced within the EU only.

In early March 2011, members of the European Parliament voted on the adoption of the “Podimata report” (an innovative financing resolution drafted by Anni Podimata) by 529 votes in favour to 127 votes against, which proposed the promotion of the introduction of a FTT. Later, on 29 June 2011, the EC published a proposal for a EU Council Decision on the system of own resources of the EU. This proposal highlighted the FTT as a key element in creating additional revenue for the EU which could reduce the contributions made independently by Member States.

It has been argued that a global FTT would be more difficult and take longer to implement than an EU FTT. Unsurprisingly, an EU FTT has also received criticism. For example, on 9 June 2011, Simon Lewis the chief Executive of the Association for Financial Markets in Europe (“**AFME**”) argued that the “real impact of a possible transaction tax needs to be understood.” He explained, using foreign currency trading as an example, that a tax would significantly increase costs in this sector at the expense of economic growth. He also noted that a FTT should be considered against “the backdrop of several significant new taxes or levies already being introduced by individual Member States...we have already called upon the [EC] to conduct a thorough study into the tax contribution made by the financial services sector.”

On 28 September 2011, the Commission published a draft Directive on a common system of FTT and amending Directive 2008/7/EC concerning indirect taxes on the raising of capital.

Under the proposals FTT would apply to all transactions in financial instruments (including bonds, shares, units in collective investment undertakings and derivatives) to which a financial institution (which includes banks, collective investment schemes, SPVs and holding companies) is party, if at least one party to the transaction is (or is treated as being) established in the EU.

The Commission proposes that the FTT should apply from 1 January 2014 but this will depend on when, and if, the Council adopts the proposal. In June 2012, just 10 out of the 27 EU Member States voted in favour of the FTT. With countries such as the UK and Netherlands vehemently opposed to the tax, it seems as though the other 10 Member States (which include Germany, Austria and Denmark) may negotiate a side agreement with the EU. However, for this to occur at least nine countries must draft a proposal and put it forward as a so-called “enhanced cooperation”. In the UK the Chancellor of the Exchequer has expressed the view that an FTT would hinder economic growth as financial institutions would choose to do business elsewhere.

6. RETAIL BANKING AND PAYMENT SERVICES

(a) Payment Services

As mentioned in our previous updates, the EU Payment Services Directive (“**PSD**”) provides the legal foundations for the Single Euro Payments Area initiative. It introduces a new licensing regime to encourage non-banks to enter the payments market, sets common standards for terms and conditions with a focus on high levels of transparency, and establishes maximum execution times for payments in euro and other EU/EEA currencies. The PSD encourages the adoption of more efficient payment types and, for some Member States, introduce a shift in liability between providers and customers in the interests of consumer protection. The EC is continuing to publish questions and answers on the PSD on its website, the most recent set of answers being posted in January 2012. The EC is expected to review the implementation of the PSD and its impact on Member States before 1 November 2012.

On 23 February 2012, the EU Council published a **note** relating to the proposed Single European Payments Area Migration Regulation. This note contains statements by the EC in relation to (i) the Single European Payments Area Governance; and (ii) the PSD. Furthermore, the SEPA Migration Regulation was adopted by the European Parliament on 14 February 2012 and it is expected to be adopted by the Council in the coming weeks.

In June 2011, the EC published revised guidelines on passport notifications under the PSD as well as new guidelines on the second Electronic Money Directive (“**2EMD**”) which is discussed further below. The PSD passport notification guidelines are a voluntary code of conduct which was first published in November 2009. They are intended to allow EU competent authorities to cooperate and exchange information to ensure an efficient passport notification process for electronic money (“**e-money**”) institutions.

2EMD aims to encourage the growth of the e-money market and was implemented in the UK on 1 May 2011 through the Electronic Money Regulations 2011 (“**EMR**”) which introduced new conduct requirements for all e-money issuers. In addition, EMR introduced new authorisation/registration and prudential standards for e-money institutions (“**EMIs**”). Among other changes which 2EMD makes, authorised EMIs are subject to a reduced initial and minimum ongoing capital requirement and all EMIs must safeguard funds received from customers for e-money so that should the EMI become insolvent the funds are protected from other creditors’ claims.

The FSA’s Banking and Payment Services conduct regime comprises the Banking Conduct of Business sourcebook (“**BCOBS**”) (the final provisions of which came into force on 1 May 2010) together with the Payment Services Regulations 2009 (“**PSR**”), which implement the PSD with effect from 1 November 2009. The PSRs broadly require certain information to be provided to the customer before and after execution of a payment transaction and deal with the rights and obligations of both payment service provider and customer in relation to payment transactions. The obligations for the former include registration as a payment service provider. In brief the BCOBS contains rules and guidance on communications with banking customers and financial promotions, the speed of customer payments (e.g. from 1 January 2012 all payments into a customer account will have to be made by close of play on the business day after the instructions are received), post-sale requirements and cancellation.

The UK Payments Council originally published guidance on the BCOBS in December 2009 and has since been updated twice, first in May 2010 and most recently in January 2011. The **guidance** has been granted industry guidance status by the FSA until 31 December 2012.

The Payment Services Regulations 2012 (“**PSR 2012**”) were published in July 2012. The PSR 2012 directly address concerns regarding the possibility of unfit persons establishing or managing small payment institutions. The Regulations came in to force on 1 Oct 2012 and will:

- give the FSA the power to check that the owners and managers of small payment institutions are fit and proper persons, and that the directors and managers of such business are of good reputation and possess appropriate knowledge and experience to provide payment services; and
- give the HMRC the power to strike a business off the register of money service businesses under the Money Laundering Regulations (“**MLR**”), if the business is providing, or is purporting to provide, a payment service when it is not authorised to do so.

The Board of the UK Payments Council has announced a target date of the 31 October 2018 for closing the cheque clearing system, provided (only) that alternative forms of payment are developed by 2016. However concerns have been aired by the Treasury Committee and the charity sector that the number of donations, particularly from older donors would go down if cheques were abolished, although it is unlikely that these will affect the timetable for reform.

The UK Domestic Cheque Guarantee Card Scheme closed on 30 June 2011. This concludes a decision made by the Payments Council in 2009 to abolish the use of cheque guarantee cards due to a decline in usage of the guaranteed cheque.

(b) Consumer Credit

1 February 2011 marked the end of the transitional period for the implementation, in the UK, of the Consumer Credit Directive (“**CCD**”) by numerous sets of regulations and amending regulations. The CCD adapts the European consumer credit regime so it is able to deal with more modern forms of credit. It is also designed to bring a greater level of consistency to the regulation of consumer credit across Europe, and to increase consumer protection through, amongst other things, increased transparency.

The regulations (the most significant of which are the Consumer Credit (EU Directive) Regulations 2010) contain a number of important changes to the existing Consumer Credit Act 1974. The regulations restrict the availability of the useful "high net worth" exemption under the Consumer Credit Act, introduce a fundamental requirement on lenders to make detailed pre-contractual credit information available in a prescribed form, oblige lenders to assist consumers in assessing the suitability of a range of credit agreements and to make their credit agreements conform with the requirements of the amended Act.

Lenders and those involved on the periphery of consumer borrowing e.g. credit intermediaries should ensure they are aware of the new requirements.

(c) Retail Distribution Review (RDR)

2012 will see the implementation of the FSA's RDR proposals which are intended to improve customer trust and confidence in the retail investment market. Under the proposals, investment firms will be required to describe the advice they offer as:

- “independent” (where advice is based on a comprehensive and fair analysis of the client’s needs);
- “restricted” (where for example, the advice relates to a limited range of products); or
- both.

The RDR proposals also contain new charging rules which will ban the payment of commission to advisors and require investment firms to set their own charges which must be agreed with clients. Furthermore, under the proposals the minimum level of qualification for all investment advisors will be raised and the FSA will supervise and enforce professional standards for individual advisors with an enhanced role for accredited bodies. Firms will need to comply with the new rules by 31 December 2012 and the FSA will be closely monitoring RDR implementation throughout 2012.

(d) Packaged Retail Investment Products (PRIP)

The EC has published its **legislative proposals** for the regulation of PRIPs. In September 2012, the Commission indicated that it will consider the proposal at the May 2013 plenary session. The proposals centre around the requirement for, and the contents of, the ‘Key Information Document’ (“**KID**”). PRIPs are investment products which are generally marketed to retail investors and which offer investors exposure to underlying assets in packaged forms. As such they involve an element of engineering which alters the client’s exposure compared with direct holdings. In order to address persistent problems with the way in which PRIPs are marketed and sold to retail investors, the EC is expected to extend the rules relating to pre-contractual disclosure and sales practices under the UCITS Directive (2009/65/EC) and the Markets in Financial Instruments Directive (2004/39/EC) to cover all PRIPs. The Commission’s proposal will now go to the European Parliament and the Council for their consideration. The full proposal could be expected to be in place by the end of 2014 and apply two years after its entry into force.

Under the legislative proposals all KIDs should have a standardised “look and feel” and be;

- accurate, fair, clear and not misleading;
- a stand-alone document;
- drawn up as a short document that is easy to read and clearly expressed, and written in language that facilitates the retail investor’s understanding of the information being communicated.

Further, the proposals state that it is up to the person selling the product to provide the KID in good time before the sale is transacted. However, investment product manufacturers will be responsible for preparing the KID.

7. CAPITAL

(a) International

Following the publication of its three papers on enhancing the existing bank capital framework: *Enhancements to the Basel II framework*, *Revisions to the Basel II market risk framework*, and *Guidelines for computing capital for incremental risk to the trading book*, the Basel Committee on Banking Supervision (“**BCBS**”) stated that it expected all firms to comply with its revised Pillar 1 (minimum capital) and Pillar 3 (market discipline) requirements on risk weighting and disclosure and its associated Pillar 2 guidance, by the 31 December 2010.

New trading book rules also took effect at the end of 2010, which introduce higher capital requirements to capture the credit risk of complex trading activities. They include a stressed value at risk requirement which the BCBS believes will help dampen the cyclicity of the minimum regulatory capital framework. In July 2010, the G20 announced in a progress report that, following its 2009 package of reforms relating to trading book risks, the BCBS has started a fundamental review of the trading book. In September 2011, the BCBS confirmed that it would review the measurement of risk-weighted assets in both the banking book and trading book, to ensure that the outcomes of the new rules are consistent in practice across banks and jurisdictions.

On 16 September 2010, the BCBS published the text of the new global regulatory standards on bank capital adequacy and liquidity, known as Basel III. The regime was agreed by the Governors and Heads of Supervision (“**GHOS**”) the oversight body of BCBS, and endorsed by the G20 Leaders at their November Seoul in 2009. The Basel III framework sets out requirements for higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a “backstop” to Basel II's risk-based capital requirements, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity ratios.

The final text of Basel III sets out the minimum level of common equity and Tier 1 capital that banks will be required to hold by 1 January 2019. Over a five year period, the core Tier 1 capital minimum will be raised from the current 2% of risk weighted assets, to 4.5% by 2015, with the overall Tier 1 capital minimum being incrementally increased to 6%. The BCBS has also agreed to introduce a 2.5% “capital conservation buffer” of common equity, designed to further cushion banks against potential losses. The buffer will be phased in from January 2016 and will become fully effective in January 2019. The combination of requirements will result in banks being required to hold a minimum of 7% common equity and 8.5% Tier 1 capital by 2019.

In addition to the above, Basel III empowers national regulators (such as the FSA) to impose a counter-cyclical buffer of up to 2.5% of assets, if they consider there to be excess credit in the system, which may result in loan losses later on. The idea being that the buffer will act as a shock absorber, should losses be incurred after the burst of the perceived credit bubble. Any bank which fails to keep its capital ratio above the imposed buffer, may incur restrictions on payouts such as dividends, share buybacks and bonuses. The UK has stated that it intends to impose the full 2.5 per cent cushion. It has also said that it may impose higher capital requirements than those proposed by the Basel Committee. In addition to being potentially harmful to competition, however, it is questionable whether the UK will be able to impose higher capital requirements when the Capital Requirements Directive 4 reforms are implemented (see below).

Alongside the Basel III text, the BCBS published an impact assessment which tested the Basel III measures, assuming full implementation as of year end 2009. No phase in period was permitted. A

total of 263 banks from 23 committee member jurisdictions participated in the assessment, including a set of 'Group 1' banks (i.e., those that have Tier 1 capital in excess of €3bn, are well diversified and are internationally active) and a set of 'Group 2' banks (i.e., other banks). The assessment found that the average common equity Tier 1 capital ratio of Group 1 banks was 5.7 per cent, as compared with the new minimum requirement of 4.5 per cent. For Group 2 banks, it was 7.8 per cent. While Nout Wellink described the Basel III Framework as "a landmark achievement that will help protect financial stability and promote sustainable economic growth," it appears to many that the agreed core tier one ratio is not high enough to cope with another similar downturn and that the implementation periods are too long. Indeed, the Bank of England ("**BoE**"), in its January 2011 paper, "**Optimal Bank Capital**" (Revised in April 2011), has said a capital adequacy ratio at least twice as large as that agreed in Basel would take the banking sector closer to an optimal position and urges banks to raise more equity capital.

The BCBS launched a consultation on the definition of capital disclosure requirements, on 19 December 2011. The consultation document (**BCBS212**) includes proposals for: common disclosure templates for pre and post-2018 disclosure; a template for banks to use to meet the Basel III requirement to provide a description of the main features of capital instruments; and how banks should meet reconciliation requirements and other disclosure requirements. The BCBS has now published its final capital disclosure requirements (**BCBS221**), substantially adopting the proposals. Banks should comply with the disclosure requirements from the date of publication of their first set of financial statements relating to a balance sheet on or after 1 January 2013.

It is clear that, in implementing Basel III, banks are going to have to provide more accurate and timely information on their capital position at any given time and this will involve increased and more efficient data management.

In a speech published on 17 October 2011, Jaime Caruana, General Manager of the Bank for International Settlements, described the actions that have been taken, or are being considered, to ensure the successful implementation of Basel III. For example, the Standards Implementation Group of the BCBS has increased the level of information-sharing among national supervisors, and the BCBS is putting in place a monitoring and review process to cover all aspects of Basel III implementation. In addition, the BCBS will carry out peer reviews, as well as thematic reviews to assess progress across jurisdictions with the implementation of specific reforms, such as the stress-testing guidance. In its meeting of 8 January 2012, the GHOS agreed that initial peer reviews should assess the implementation of Basel III in the European Union, Japan and the United States. The reviews have now commenced.

On 4 November 2011, the BCBS published its final rules (**BCBS207**) in relation to additional capital requirements for globally systemically important banks ("**G-SIBS**"). The measures are intended to improve the resilience of G-SIBS and create strong incentives for them to decrease their systemic importance.

The final rules, and accompanying cover note, set out the methodology for assessing systemic importance, the additional capital required and the arrangements by which the measures will be phased in. The assessment methodology takes an indicator-based approach which comprises five categories: size; interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. A Common Equity Tier 1 ("**CET1**") capital requirement ranging from 1%-2.5% depending upon systemic importance will be used to address additional loss absorbency requirements. However, the BCBS supports the use of contingent capital to meet any national loss absorbency requirements

that are higher than the BCBS's requirements. An additional 1% surcharge is introduced as a disincentive for banks which may be increasing materially their global systemic importance.

The higher loss absorbency requirements will be phased in alongside the Basel III capital conservation and countercyclical buffers, between 1 January 2016 and the end of 2018, becoming fully effective in 1 January 2019. National jurisdictions are expected to incorporate the rules into legislation by 1 January 2014.

(a) Europe

In light of the Basel III proposals, the EC has published a series of proposals on amending the Capital Requirements Directive ("CRD"), which applies to banks, building societies and certain types of investment firm. The amendments to the Directive aim to maximise the effectiveness of the capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers.

A new **Directive** amending the CRD (labelled "**CRD2**") was adopted in September 2009 and Member States were required to transpose the Directive by 31 October 2010 (see below for the UK). CRD2 seeks to strengthen the supervision of cross-border banking groups by requiring close coordination between the supervisor of the member state where the parent undertaking is located, and the supervisors of its subsidiaries with regard to risk assessment and additional capital requirements. Reporting requirements will be fully harmonised at European level by 2012 and colleges of supervisors, chaired by the supervisor of the parent undertaking, will be established for all cross-border groups. The role of CEBS (now the EBA) has been strengthened and the mandates of national supervisory authorities are given a European dimension.

The Directive also seeks to improve the framework for securitisation practices by obliging originators to retain significant interests in risks transferred onto investors. The classification of hybrid instruments has been harmonised and a central role has been given to CEBS in ensuring greater uniformity of supervisors' practices. New rules on liquidity risk management have been introduced, in particular with regard to the setting up of liquid asset reserves, conducting liquidity stress tests and establishing contingency plans. The supervision of exposures to single counterparties, whatever their nature, have been tightened (in all cases, the limit is 25% of banks' own funds).

A second set of amendments to the CRD ("**CRD3**") were adopted in October 2010. Its provisions relate to capital requirements (re-securitisations, disclosure of securitisation risks and trading book, as prescribed by Basel III) and to remuneration (as discussed above). The relevant CRD3 rules have now been transposed into UK Legislation and Regulation.

On 28 April 2011, the EBA announced revisions to the Common Reporting Framework ("**COREP**") templates - namely: Capital and Group solvency Details, Credit Risk, Market Risk and Operational risk - in order to incorporate amendments made to the CRD by CRD3. The COREP framework is used by credit institutions and investment firms when reporting their solvency ratio to supervisory authorities under CRD. These changes have been applicable since 31 December 2011.

Legislative proposals for a regulation and a directive which comprise the package of reforms known as CRD4 were published on 20 July 2011 by the EC. It is proposed that the new regulation and directive will replace and recast the Banking Consolidation Directive (2006/48/EC) and the Capital Adequacy Directive (2006/49/EC) which together currently comprise the CRD. The CRD IV package will consist of the Capital Requirements Directive and the Capital Requirements Regulation ("**CRR**"). The CRD IV comprises a review of the EU's legislation and prudential requirements for credit

institutions and investment firms. The intention of CRD IV is to simplify the current requirements by unifying the prudential requirements for credit institutions and for investment firms and by integrating the annexes of the Directives 2006/48/EC and 2006/49/EC into the regulation and the directive. The proposed directive and regulation are intended to be in force on 1 January 2013, with full implementation expected by 1 January 2019.

CRD4 will implement the Basel III reforms agreed in December 2010 but the content of the new regulation and directive does not exclusively contain Basel III reforms - there are a number of reform proposals in the areas of corporate governance, supervision and sanctions for instance, which go beyond Basel III. It also sets out the EC's proposals for a single set of harmonised prudential rules, known as the single rule book. In terms of coverage, CRD4 will apply Basel III to a broader range of firms including MiFID investment firms which is beyond the remit intended by Basel III.

The proposed regulation comprises detailed quantitative requirements and has direct effect, thus restricting the discretion of national supervisors when applying the provisions. The regulation contains provisions which relate largely to the single rule book such as: quality of capital, quantity of capital, counterparty credit risk, leverage and liquidity.

The new directive is less prescriptive and reflects the necessary interaction of the proposed reforms with respective national laws. It covers areas such as: authorisation of credit institutions and their passporting rights; corporate governance; sanctions and reforms relating to capital buffers covered by Basel III.

Following the publication of legislative proposals in July 2011, the next stage for CRD IV is for the legislative negotiation process between the EC, the EU Council and the European Parliament to be concluded. With the European Parliament expected during 19-22 November to vote in a plenary session before formal political agreement is reached on the final text of the CRD IV. The deadline for Member States to implement the proposed directive and for the proposed regulation to come into force is 1 January 2013, as stated by the EC on its legislative proposals in July 2011. Member states were expected to transpose the CRD IV into national law by 31 December 2012. However, regulatory and industry bodies have raised doubts as to whether the January 1 deadline is realistic due to the delay to CRD IV caused by political agreement. Full implementation of the requirements is expected by 1 January 2019.

(b) United Kingdom

The FSA has implemented CRD2 and CRD3 primarily through amendments to the GENPRU and BIPRU sections of its Handbook, with all such amendments coming into force before 1 January 2011 in accordance with the required time frame. The amendments include those related to remuneration discussed above.

The FSA will be responsible for managing the implementation of CRD IV. The FSA has stated that the CRD directive will be transposed through "a mixture of Treasury regulations and FSA Handbook". In a [statement](#) published on 1 August 2012, the FSA commented that following the delay of the European Parliament's plenary vote the implementation date of 1 January 2013 does not seem feasible. Further, no alternative date has yet been communicated by the EU institutions.

The FSA has also outlined proposals to amend the rules relating to the capital planning buffer under the Prudential Sourcebook for Banks, Building Societies and Investment Firms ("**BIPRU**"). The FSA

expects the capital planning buffer to be set at levels that enables firms to meet their relevant capital ratios at all economic cycle stages. The FSA may specify that elements of the capital planning buffer be held in particular forms of capital. The draft amendments to BIPRU are set out in the schedule to the consultation paper. **Policy statement 10/14** on capital planning buffers for credit institutions was published on 24 September 2010 which gives feedback on consultation paper **09/30** and sets out the final rules which came into effect immediately on publication on 24 September 2010. It has been said that the rules do not effect any major Handbook amendments, but that they clarify the FSA's approach in practice to setting capital planning buffers.

Although the FSA is responsible for implementing the majority of the amendments to the CRD, HM Treasury is responsible for transposing provisions on supervisory arrangements and new EU regulations on Credit Rating Agencies. In October 2010, HM Treasury published the Capital Requirements (Amendment) Regulations 2010 (*SI2010/2628*) together with an explanatory memorandum which set out the CRD2 rules on the recognition of credit ratings agencies and its response to issues arising from its January 2010 consultation on the topic.

The FSA consultation paper **CP11/9** "Strengthening Capital Standards 3: further consultation on CRD3" was published in May 2011. This paper is an update to CP09/29 which set out the FSA's proposals for implementing the changes to CRD made by CRD2 and CRD3. As already mentioned, the deadline for transposition of CRD3 requirements is 31 December 2011. On 3 November 2011, a policy statement, **PS11/12**, was published by the FSA containing the feedback it had received to CP11/9 and the final rules. As mentioned above, the relevant CRD3 rules have now been transposed into UK Legislation and Regulation.

In February 2010, the AFME published good practice guidelines on the CRD securitisation disclosure requirements. The guidelines are proposed to ensure adequate and consistent compliance with the CRD requirements, and the AFME recommended that firms adopt these guidelines when making disclosures from the period beginning 1 January 2011.

In September 2012, the FSA published a **statement** stating that where firms increase UK lending (measured by the metric of the Funding for Lending Scheme), the FSA will make an allowance for this increase in the minimum Pillar 1 capital requirements by reducing the Pillar 2 capital planning buffer requirements. This will ensure that such banks will not have to hold additional capital requirements for the increased lending.

8. LIQUIDITY REQUIREMENTS

(a) International

The final text of Basel III confirmed that the timescale for implementation of the Net Stable Funding Ratio (which is a measurement of a bank's vulnerability to liquidity changes) has been extended; it will now be introduced in 2018 rather than 2013. The Liquidity Cover Ratio ("**LCR**"), which is designed to measure whether banks hold an adequate level of unencumbered, high-quality liquid assets to meet net cash outflows under a 30- day stress scenario, will be introduced in 2015.

The BCBS published a set of frequently asked questions on the Basel III liquidity framework in July 2011. This is a response to interpretation questions which they received following the December 2010 publication of the Basel III regulatory frameworks for capital and liquidity. The production of answers to frequently asked questions is part of BCBS's approach to ensure consistent global implementation of Basel III.

Lastly, the BCBS has recently confirmed that, by the end of 2012, it will publish recommendations on the following issues related to the LCR:

- Clarification that the 100% liquidity threshold will be a minimum requirement in normal times, but during a period of stress banks would be expected to use their pool of liquidity assets, and so fall temporarily below the minimum requirement. The BCBS will also provide additional guidance on the circumstances that would justify the use of the pool.
- The interaction between banks and central banks during periods of stress, to ensure that the LCR's workings do not hinder or conflict with central bank policies.
- Adjustments to the calibration of net cash outflows.

(c) Europe

The EC will implement the Basel III reforms on liquidity requirement through CRD IV.

(d) United Kingdom

A tough new liquidity regime came into force in the UK in December 2009 (the policy for which is contained in the FSA's Policy Statement [PS09/16](#) "Strengthening liquidity standards" October 2009). The regime introduced new liquidity reporting and quantitative requirements, coupled with a narrower definition of liquid assets. The build up of liquidity buffers will only be implemented once the economy has stabilised. The new rules discourage reliance on short-term wholesale funding, enhance systems and controls requirements, which implement the Basel Committee's updated Principles for Sound Liquidity Risk Management and Supervision, and increase the quality and quantity of liquid asset buffers. Whilst most elements of the regime are to be phased in gradually, the systems and controls requirements came into effect on 1 December 2009.

The FSA initially aimed to phase in tightened quantitative liquidity standards in the years following the introduction of the regime. However, in March 2010, the FSA [published](#) a statement stating that it would be "premature" to increase the liquidity requirements at that time as it was continuing to "work with firms that are most affected by the new regime focusing on the steps they are taking to mitigate liquidity risk", as well as contributing to the international debate on liquidity. On 18 November 2010, the FSA published a statement stating that the Basel Committee has moved further towards introducing minimum global liquidity requirements that would be implemented through EU law and that the FSA will consider how best to calibrate the UK regime once these international proposals have been finalised.

In Quarterly Consultation Paper no. 27 published on 6 January 2011 ([CP11/1](#)), the FSA proposed minor amendments to BIPRU. This contained proposals in relation to transitional provisions for simplified firms (ILAS BIPRU firms - which are any firms within the scope of BIPRU 12). The proposals extend the transitional period to be allowed to ILAS BIPRU firms by 15 months, (currently until 1 October 2013) to reach 100% of their simplified buffer requirement. Via proposed amendments to the liquid assets buffer scalar, ILAS BIPRU firms would be required to hold: 30% of their simplified

buffer requirement until 28 February 2012; 50% until 30 June 2013; 70% until 31 December 31 December 2014 and 100% thereafter at which point the transitional period would cease to apply.

In the same publication, the FSA also proposed amending the definition of “low frequency liquidity reporting firm” to allow branches’ reporting frequency to depend on balance sheet assets attributable to the UK branch, rather than the size of the balance sheet of the firm as a whole (which is currently determined by a balance sheet of a size less than £1bn and requires monthly rather than weekly reporting). The FSA expects the effect of this proposal to increase the number of branches which report monthly rather than weekly. The deadline for comments on these proposals closed on 17 February 2011 and the FSA confirmed in March 2011 in its [Handbook Notice 108](#) that it would proceed with these proposals but further extended the transitional period for simplified firms to 31 December 2015.

More recently, the FSA has consulted on further minor amendments to the liquidity regime in Quarterly Consultation Paper No. 29 published on 6 June 2011 (Chapter 4 of [CP11/11](#)). The proposed amendments cover, among other things, the reporting requirements related to firms’ sterling, US dollar and euro-denominated wholesale liabilities and the associated guidance; amendment to the definition of “DLG by default”; corrections and amendments to the simplified ILAS approach. This has now been implemented since our September 2011 update by the Liquidity Standards (Miscellaneous amendments No 3) Instrument 2011 (FSA 2011/52) which came into force on 1 November 2011.

In Consultation Paper 30 ([CP11/18](#)), which was published in September 2011, the FSA consulted on further proposed amendments to the liquidity regime, namely: a change to the treatment of collateral held with a central bank in excess of requirements; an amendment to the definition of small and medium-sized enterprise (SME) deposit; and an amendment to certain reporting guidance in SUP (FSA’s supervision sourcebook) relating to securities issued by group entities. In January 2012, the FSA published the final rules on the issue which can be found in the Liquidity Standards (Miscellaneous Amendments No 4) Instrument 2012 (FSA 2012/4). These amendments came into force on 20 January 2012.

The FSA indicated in its business plan for 2011/12 that it would focus on implementing the liquidity regime for firms through its intensive supervisory approach rather than negotiating and developing policy. In line with this, the FSA has recently published a [statement](#) outlining adjustments to bank’s liquidity regimes. The FSA makes clear to firms that all of their buffer can be used in times of stress, and that firms will be given reasonable time to rebuild their buffers subsequently.

9. STRESS TESTING

(a) Europe

Following its publication of the results of the 2010 EU stress tests, CEBS went on to publish its final [guidelines](#) on stress testing. The guidelines are intended to assist institutions in designing and implementing stress testing programmes with a robust governance structure, meaningful senior management engagement and effective infrastructure. The guidelines will also assist supervisors in their assessments of institutions’ stress testing. CEBS expected its members to apply the guidelines from 31 December 2010.

The EBA published the results of its EU wide stress test for 2011 on 15 July 2011. The 2011 stress test, which was applied to 9- banks, comprised the following key features:

- new consistent capital benchmark of 5% core tier 1 capital. The capital threshold for 2011 will be focused on a definition of core tier 1 capital which is more restrictive than that used in 2010;
- common baseline and adverse scenario by the EC and ECB. The 2011 adverse scenario has been designed to be more severe than 2010 CEBS exercise in terms of deviation from baseline forecast and probability that it materialises;
- a quality assurance and peer review process was conducted by the EBA and ESRB between March and June 2011; and
- the results include clear disclosure of credit and sovereign exposures.

Ahead of this stress test, banks were given an incentive to strengthen their capital positions as the EBA allowed specific capital increases made in the first four months of 2011 to be taken into account. Further, on the basis of the 2011 stress test results, the EBA issued its first formal recommendation that national supervisory authorities should require banks to remedy promptly any capital shortfall below the 5% core tier 1 capital threshold. The EBA also recommended that banks with a core tier 1 capital ratio above but close to 5% which also had significant exposure to sovereigns under stress, should strengthen their capital position. Moreover, the EBA produced a [progress report](#) dated April 2012, in respect of these recommendations. The EBA stated that in general it is satisfied with the fulfilment of the July 2011 recommendations. It notes that action taken includes capital strengthening and adequate recognition of losses. Further, it notes that banks identified as having weaknesses have subsequently undergone restructuring and will no longer exist in the same form as at the time of the stress test.

(b) United Kingdom

Under the FSA's [stress test policy](#), published in December 2009, firms are expected to implement robust and effective stress testing programmes (including reverse stress testing) which assess their ability to meet capital and liquidity requirements in stressed conditions. The FSA will also stress test a number of firms on a periodic basis to assess their ability to meet minimal capital levels throughout a stress period. The FSA updated its [stress testing website](#) in August 2010 to remind firms to submit their implementation plan templates, and to list a number of surgeries held in September and October 2010, which provided feedback on stress testing issues and case studies.

The FSA published [Frequently Asked Questions](#) in relation to reverse stress testing on its website on 18 May 2011.

10. CLIENT MONEY

As we touched on in our previous alerts, the FSA has upped its monitoring of firms' compliance with the existing Client Assets Sourcebook ("**CASS**") regime.

In March 2009, the FSA wrote to firms' compliance officers reminding them of the CASS requirements to protect client money and assets, and announced it was embarking on visits to authorised firms to

further assess their compliance with CASS. During its firm visits in 2009 the FSA identified a number of particular failings by firms, including inadequate management oversight and control, unclear arrangements for segregation of client money, lack of establishment of trust status for segregated accounts, limited due diligence and review of banks, credit institutions or qualifying market funds used for holding client money, and incomplete or inaccurate records, accounts and reconciliations. In June 2010, the FSA issued its largest ever fine to JP Morgan Securities Ltd (£33 million) for failing to segregate client money appropriately.

More recently, on 8 December 2011, the FSA issued a final notice to Integrated Financial Arrangements Plc, a wrap platform provider, fining it £3.5 million for breaches of the client money rules.

Partially in response to its firm visits, a number of initiatives have been undertaken by HM Treasury and the FSA to address what are perceived as serious failings in firms' handling of client money, and weaknesses in the current client assets regime. The initiatives include the following:

- CF10: the FSA have created a new 'controlled function' for client assets oversight. This is known as control function CF10a ;
- CMAR: re-introducing a client money and asset return (the "**CMAR**"). The CMAR must be reviewed and authorised by the individual holding the CF10a controlled function, on a monthly basis for medium and large firms, and bi-annually for small firms, based on the FSA's proposed firm classification framework. Firms were obliged, under CASS 1, to categorise themselves as small, medium or large by 31 January 2011 and notify the FSA of their client money figures.
- On 10 February 2011, the FSA published a consultation paper (**CP11/04**) on the operational implementation of the CMAR which is to be submitted via GABRIEL, the FSA's online information gathering system. The period for comment closed on 10 April 2011 and the FSA issued a policy statement on the topic on 27 May 2011 (**PS11/06**). This policy statement reports on the main issues arising from the consultation and publishes final rules for CASS medium and large firms. Proposals in relation to CASS small firms reporting arrangements and their related final rules were published slightly earlier in FSA Handbook Notice on 3 May 2011.
- Title Transfer Collateral Agreements ("**TTCA**"): the FSA restricted the use of TTCAs (under which a client agrees that monies or assets should be treated as collateral in respect of the firm's arrangements and that full ownership is transferred unconditionally to the firm) in relation to margin payments held by CFD and spreadbetting market-makers to non-retail clients.
- The FSA extended the prohibition of the use of TTCA to rolling spot forex contracts offered to retail clients in the form of a futures contract and a contract for difference ("**CFD**").
- The FSA has confirmed in **CP11/15** and **Handbook Notice 113** that it will continue to monitor the utilisation of TTCAs with retail clients (in other contexts) on a periodic basis and act accordingly. There have also been propositions by the EC that the ability to enter into to TTCAs with retail clients be completely restricted.
- The FSA provided further guidance in CASS 7.2.10AG as a consequence of the inappropriate use of the 'money due and payable' provisions found CASS 7.2.9R. This guidance reminds firms of their obligation to segregate client money in accordance with the standard method of internal money reconciliation, or a different method meeting the requirements of CASS 7.6.7R and CASS 7.6.8R.
- Under CASS 7.4.9A R, the FSA restricted the amount in client bank accounts held with institutions within the same group, to 20% of the firm's total client money. This limit applies to

general client bank accounts, designated client bank accounts and designated client fund accounts. However, the limit does not apply to the client transaction accounts.

- CASS 9 requires firms conducting prime brokerage business to include re-hypothecation transparency and disclosure requirements in their agreements with their prime brokerage clients. These requirements only apply to UK authorised prime brokers at the moment. However, in order to ensure a level playing field, the FSA intends to consider whether these proposals should be applied more broadly to other market participants who enter into "rights of use" arrangements.
- HM Treasury proposals on client money and assets. These proposals are part of the Treasury's work on establishing effective resolution arrangements for investment banks. The proposals deal particularly with how client assets and monies are treated on the insolvency of the bank. The government has introduced the Investment Bank Special Administration Regulations 2011 and the Investment Bank (Amendment of Definition) Order 2011 into Parliament. One of the objectives of this legislation is to ensure that client assets and money held on trust by an investment firm can be returned by an administrator as quickly as possible in the event of the investment firm's insolvency.
- Ban on inappropriate general liens in custodian agreements. This prohibition is provided for by CASS 6.3.5R. Notwithstanding certain exceptions, the firm must ensure that a third party agreement by which the firm deposits safe custody assets belonging to a client does not include a lien, right of retention or sale over those assets or any client money derived from them. This new rule applies to UK authorised investment firms as well as their overseas branches.
- This prohibition initially applied to all agreements entered into after 1 March 2011. This also included a transitional provision until 1 October 2011 enabling firms to re-paper existing agreements. However, in [Handbook Notice 113](#), it was provided that CASS 6.3.5R was to be switched off for all agreements subject to the rule from 1 October 2011 to 31 March 2012. In the interim, guidance was re-introduced by CASS 6.3.3G(4) which required firms to consider any liens when entering into custody agreements.
- In relation to liens over omnibus accounts, the FSA proposed in [CP11/15](#) to change the requirements in CASS 6.3.6R to allow certain exceptions. The FSA has published its [policy statement](#) following the consultation and has decided to amend the rule and provide for an exception that allows a general lien to be granted if such a lien is necessary for an individual firm to gain access to a local market. The FSA has further proposed an amendment that permits a lien over an omnibus account held at securities depositories, securities settlement systems or central counterparties for facilitating the settlement of a particular client's trades. Firms have until 30 September 2012 to ensure that any custody agreements entered into before 1 April 2012 comply with these rules.
- CASS Resolution Pack ("**CASS RP**"). The FSA consulted on these proposals in August 2011. Upon the failure of a firm, it is intended that the CASS RP will promote a speedier return of client money and assets to the client by making client money and asset information readily available to the insolvency practitioner appointed by the failed firm. This will apply to all firms subject to CASS 6 or CASS 7 and the FSA has proposed to include the new rules in Chapter 10 of CASS. A policy statement containing the final rules has been published ([PS 12/6](#)).
- In [CP10/20](#), the FSA has consulted on proposals to improve the quality and consistency of auditor's reports on client assets. In policy statement [PS11/5](#), the FSA confirmed that it would move ahead with all the proposals set out in CP10/20. The rules came into force on 1 June 2011 and auditors' client assets reports with a period ending 30 September 2011 and onwards are required to follow the new rules.

The FSA has recently published a consultation paper (CP12/22) proposing a number of changes to the client money and custody assets regime for firms undertaking investment business as set out in CASS. The FSA's primary concern is with the protection of client asset pools on the insolvency of investment firms. Further, the consultation proposals bring the client assets regime in line with the European Market Infrastructure Regime ("EMIR"). The paper is split up in to the following three parts:

- (i) changes to the FSA's client assets regime to bring it into line with the segregation and portability requirements under EMIR;
- (ii) proposals to allow investment firms to operate multiple client money pools that will be legally and operationally separate; and
- (iii) overview of the FSA's fundamental review of its client assets regime, which focuses on improving the regime on the insolvency of an investment firm.

In relation to the first of the proposals the FSA recommends to modify its client money rules in Chapter 7 CASS so that on a firm's insolvency; (i) client money held as margin at clearing houses can be transferred with cleared client positions, instead of being pooled with the other client money held by the firm; and (ii) any balance owed by the clearing house to the clearing member's clients can be returned to them.

The FSA has described the second of its proposals as the most radical changes to have been made to the client money regime in over 20 years. Under this proposal the FSA intends to introduce "multiple client money pools". Under the current regime all client money is treated as part of a single pool in the insolvency of an investment firm. However, under the new proposals firms will be allowed to operate legally and operationally separate client money pools. This ensures that client losses are segregated to the funds of a particular client as opposed to being shared. The FSA is also consulting on the possibility of permitting firms to have discretion to create specific sub-pools based, for example, on a class of clients or business lines.

The final part of the consultation comprises of a discussion paper which provides an overview of the FSA's fundamental review of the client money and custody assets regime. The objectives of the review are to:

- improve the speed of return of client assets following the insolvency of an investment firm;
- reduce the market impact of an insolvency of an investment firm that holds client assets; and
- achieve a greater return of client assets to clients following an insolvency of an investment firm.

The FSA is currently awaiting on comments, and hopes to publish a final feedback in the first half of 2013.

11. FINANCIAL REPORTING

In October 2009, the FSA published a **discussion paper** on enhancing financial reporting disclosures by UK credit institutions. The paper proposes addressing disclosure issues by either requiring the use of specified disclosure templates or by the application of a voluntary code for financial reporting disclosure. A draft code on financial reporting disclosure, developed by the BBA, is included amongst the annexes to the discussion paper.

The FSA are focusing on the transaction reporting requirements, and taking enforcement actions when firms have not complied. In April 2010 the FSA fined six companies, including four companies in the Credit Suisse group, a total of £4.2m for such compliance issues. Firms therefore need to ensure that their transaction reporting policies are comprehensive so that any errors arise early on. In addition firms that rely on third parties to report their transactions should take steps to follow up with the third party to ensure that it is correctly reporting the transactions.

The FSA published **feedback statement 09/03** in September 2010 which outlines issues raised as a result of the consultation, an assessment of current compliance with the draft BBA code and changes to the final BBA code made as a result. The statement also sets out the FSA's expectations for firms' 2010 financial disclosures.

On the 10 March 2011, the FSA and the Financial Reporting Council ("**FRC**") jointly published a feedback statement as a summary of their response to a joint paper discussing improving the role of auditors in prudential regulation. Among other initiatives, the FSA is developing a draft code of practice in conjunction with the BoE and is formalising cooperative arrangements between the FRC's Audit Inspection Unit and the FSA in a Memorandum of Understanding.

12. SPECIAL RESOLUTION REGIME

Part 1 of the Banking Act 2009, which came into force on 21 February 2009, creates a special resolution regime ("**SRR**") for dealing with UK banks that get into financial difficulty. The SRR consists of three stabilisation (pre-insolvency) options, a bank insolvency procedure and a bank administration procedure.

The three stabilisation options are the ability to transfer part or all of a failing bank or building society to a private sector purchaser, a publicly controlled bridge bank (a company wholly owned and controlled by the BoE), and to temporary public ownership (to a nominee of the Treasury).

There had been concern that the ability to transfer part of a failing bank would lead to legal uncertainty and a reduction in confidence of counterparties in doing business with such firms, especially for those counterparties entering into close-out netting arrangements.

The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (more commonly known as the Safeguards Order) protects transactions commonly found in set-off, netting and collateral arrangements from being partially transferred to another entity. The protection extends to swaps, options, futures contracts, contracts for difference and other types of derivatives contracts. Despite

this protection, the general lack of clarity surrounding the partial transfer of rights may make potential counterparties more hesitant in dealing with UK banking entities. To date, the only example of the BoE exercising its powers under the Banking Act 2009 to transfer liabilities from a failing bank or building society is in the case of the Dunfermline Building Society. In this case, part of the business of the building society was transferred to a private sector purchaser, Nationwide Building Society, and part was transferred to a bridge bank.

Although the Tripartite Authorities have acknowledged that such powers may remove or adversely affect property, employment and other rights, they believe it justified in relation to the European Convention on Human Rights on “strong public interest grounds.”

The Banking Liaison Panel, consisting of representatives of the Treasury, FSA, the BoE, the Financial Services Compensation Scheme (“**FSCS**”) and the banking sector, together with financial law and insolvency experts has ongoing responsibilities to keep the powers and regulations of the regime under review.

13. SPECIAL ADMINISTRATION REGIME

On 16 September 2010 the UK Treasury published its final consultation paper seeking views on its proposals for a new Special Administration Regime for investment firms. Draft regulations were published in draft in early 2011, including changes resulting from the consultation, and on 8 February 2011, the final Investment Bank Special Administration Regulations 2011 (*SI 2011/245*) and The Investment Bank (Amendment of Definition) Order 2011 (*SI 2011/239*) came into effect. The regulations provide for a single “special administration” procedure (“**SAR**”) for insolvent investment banks.

The Banking Act 2009 excludes investment banks from the new Bank Insolvency and Bank Administration procedure it provides for but only to the extent to which they are not authorised as deposit-taking institutions. However, HM Treasury retained the power to introduce future legislation modifying insolvency law in relation to investment banks. Section 232 of the Banking Act 2009, in summary, defines an “investment bank” as an institution that is authorised to carry on certain regulated activities related to investments, that holds client assets and is incorporated or formed under UK law.

In the wake of the collapse of Lehman Brothers Limited in 2008 and the ensuing confusion regarding client assets and ownership, the SAR aims to facilitate an investment bank’s assets being either returned to clients, or retained if the bank can be rescued as a going concern. The following special administration objectives (“**SAOs**”) will apply to an administrator appointed under the SAR regime:

- SAO 1: to ensure the return of client assets as soon as is reasonably practicable. The CASS RP mentioned above complements the operation of this objective;
- SAO 2: to ensure timely engagement with market infrastructure bodies and the Authorities (being the Treasury, the FSA and the BoE); and
- SAO 3: to rescue the investment bank as a going concern, or else to wind it up in the best interests of its creditors.

An SAR administrator can be appointed by any party who would be entitled to appoint a non SAR administrator on the grounds of insolvency. The FSA has power, after consulting with the Treasury and the BoE, to direct a SAR administrator to prioritise one or more SAOs if it is in the interests of financial stability or the maintenance of public confidence to do so. Other changes from the usual administration regime include the power of the administrator to make distributions to creditors and to take action for wrongful or fraudulent trading. Such powers are currently reserved for liquidators only. As many large banks in the UK operate both investment banking and deposit-taking arms, the Government proposes to enable both arms of such banks to be dealt with under a single insolvency procedure. As such, where an investment bank is also a deposit taking institution, the FSA may apply to the court to place the bank in a modified form of bank insolvency or bank administration, where the administrator is obliged to pursue dual objectives which include the SAOs.

14. PRODUCT INTERVENTION

The FSA published a discussion paper (DP11/01) on product intervention on 25 January 2011, which contained controversial proposals for the FSA (through the new Financial Conduct Authority (“FCA”) to have the power to pre-approve products, ban products, intervene on pricing (e.g. through fee caps) and mandate risk warnings.

The HM Treasury, in its February 2011 consultation paper entitled “A New Approach to Financial Regulation: Building a Stronger System”, also considered the scope of the product intervention powers of the new FCA.

On 14 June 2011 the FSA published its Product Intervention feedback statement (FS11/3) in response to DP11/01. The discussion paper and the feedback statement reflect the wider debate about the regulatory philosophy to be adopted by the FCA as one of the proposed successors to the FSA and the future of financial regulation in the UK as a whole. The FSA’s Business Plan 2011/12 highlights the emphasis that the FSA now places on product intervention as an integral part of its consumer protection strategy. In the feedback statement, the FSA has posited the development of a single set of rules and guidance on product governance building upon existing principles, systems and control rules and TCF guidance.

On 3 May 2012 the FSA published its FCA statement of policy on making temporary product intervention rules. The statement outlines that the FCA may publish temporary product intervention rules if it considers it necessary or expedient where the delay involved in complying with the requirements for public consultation would prejudice the interests of consumers. Temporary rules will in fact be limited in duration, but may be necessary to offer protection to consumers in the short term. The FCA may make such rules for the purpose of fulfilling its objectives of consumer protection, competition or market integrity, together with the consideration of certain relevant factors.

15. OTC DERIVATIVE REFORM

(a) International

Over the counter (“**OTC**”) derivatives trading and the perceived risk surrounding the activity, continues to generate much discussion amongst regulators. The lack of public information available on the valuation of underlying assets (particularly in the context of certain bespoke credit derivative transactions), the price formulation of contracts and the potential domino effect that can result from the lack of a central counterparty, has been said to have perpetuated the financial crisis. This view led to the G20 leaders’ agreement in September 2009 that:

- “all standardised OTC derivatives contracts should be traded on exchanges...and cleared through a central counterparty by the end of 2012 at the latest;
- OTC derivative contracts should be reported to trade repositories; and
- Non-centrally cleared contracts should be subject to higher capital requirements.”

On 15 April 2011, the Financial Stability Board (“**FSB**”) published its **first progress report**, based upon a survey conducted in January 2011, on the implementation of the G20 reforms of the OTC derivatives market. This was followed by a **progress report** published by the International Swaps and Derivatives Association (“**ISDA**”) published on 13 May 2011.

Since the February 2012 alert, the FSB has published its **third progress report** regarding the implementation of the OTC derivatives market reforms. The FSB notes that “encouraging progress” has been made with regards to setting international standards and the practical implementation of the reforms, however much remains to be completed before the end of the 2012 deadline. In particular, the jurisdictions with the largest markets in OTC derivatives (the EU, Japan and the US) are most advance in structuring their legislative frameworks and are on course to meet the 2012 deadline.

At the November 2011 Cannes summit, the G20’s final declaration endorsed the FSBs progress report on the implementation of reforms to the OTC derivatives markets. It also called on the BCBS and IOSCO to develop consultation standards on margining for non-centrally cleared OTC derivatives. The BCBS has recently published a **consultation paper** regarding the possibility of setting appropriate margining practices for all non-centrally cleared OTC derivative transactions. It is hoped that margin requirements will reduce system risk in derivative transactions. In April 2012 the IOSCO and CPSS issued their “**Principles for Financial Market Infrastructures**”. The report contains 24 principles which will harmonise and strengthen existing procedures whilst also incorporating additional guidance for OTC derivatives.

(b) Europe

As mentioned in the February 2012 update, following a period of consultation ending on 10 July 2010, the EC published a proposal for a Regulation on OTC derivatives, central counterparties and trade repositories known as EMIR. EMIR has now come in to effect (see below).

The EMIR makes the use of a central clearing party (“**CCP**”) compulsory for certain OTC derivative contracts and traders (subject to threshold conditions), and attempts to improve risk and collateral

management in those contracts where a CCP is not required. It also imposes an obligation on certain counterparties to report all OTC derivatives (whether or not cleared) to a registered “*trade repository*” (“**reporting obligation**”), which will, in turn, be under a duty to make information available to the relevant member state regulators. Further provisions deal with the management and governance of the CCPs and trade repositories which will necessarily be established for the purpose of compliance with the Regulation. Due to the global nature of derivatives trading, the EMIR has been drafted with the express intention of aligning its requirements with the similar reforms proposed in the US, under the Dodd-Frank Act.

The final text of EMIR was published in on 27 July 2012 and the Regulation entered into force on 16 August 2012. However, the Regulation is to be developed further by means of delegated or implementing acts (Level 2 measures) and those will apply from the date those acts take effect. The obligation to make use of the CCP will not take effect until summer 2013, whilst the reporting obligation is expected to come into effect on 1 July 2013, or if no trade repository has been registered for that particular derivative on 1 May 2013, then 60 days after the registration of such a trade repository. In September 2012, ESMA published the **draft technical standards on OTC derivatives**. The draft technical standards will be sent to the European Commission by 30 September 2012 and the Commission will then have 3 months to decide on whether it wishes to accept the standards.

Depending on the threshold conditions developed by ESMA, is likely that EMIR will increase compliance cost significantly for OTC traders.

(c) United Kingdom

The FSA Director of Markets, Alexander Justham gave a speech on OTC derivatives in June 2011 at the International Derivatives Expo in London. He set out action points for firms and market participants which included engaging with ESMA during its drafting of detailed rules for a mandatory clearing system. He also expressed concern that inconsistencies between EMIR and the Dodd Frank Act, for example in the area of product exemption do not create arbitrage opportunities. He also urged firms to continue to prepare for the major changes which will result from the implementation of mandatory clearing, despite this still being some way off.

Furthermore, the FSA’s finalised guidance on its review of counterparty credit risk management by CCPs (**FG12/3**) was published in January 2012. This addressed the process by which the FSA intend to undertake reviews of counterparty credit risk management by CCPs. The FSA has also published a consultation paper (**CP12/22**) relating to changes with EMIR (see section 10 “Client Money” for more information).

In June 2012, FSA Acting Director of Markets David Lawton gave a speech updating the progress report on OTC derivatives reform presented by Alexander Justham (see above). Mr Lawton identified four areas where further progress is needed:

- rules for bilateral collateralisation of uncleared trades;
- tools to assist the recovery or resolution of CCPs;
- agreeing on cross-border application of EMIR;
- ensuring readiness of firms, both financial and non-financial, not currently clearing OTC derivative trades.

Further, he warns that firms will need to be ready to comply with much of EMIR from January 2013 and that (as stated above) the first clearing obligations will be imposed on counterparties around mid 2013.

16. REVIEW OF THE MARKET IN FINANCIAL INSTRUMENTS DIRECTIVE (“MiFID”)

The EC considers that the existing MiFID framework (which is essentially based on shares and regulated markets) must be updated to capture today’s more complex market reality. Such reality is characterised by an increasing diversity in financial instruments and methods of trading. The focus, above all, is on transparency.

The EC published its legislative proposals for the review of the MiFID on 20 October 2011. The EC’s proposals comprise of a draft Directive (“**MiFID II**”) and a draft Regulation (“**MiFIR**”), which together will replace MiFID. MiFIR will allow the EC to achieve a set of uniform rules across some areas whilst allowing a certain amount of divergence through MiFID II.

The EC’s legislative proposals will now be subject to trilogue discussions between the Council of the EU, the European Parliament and the EC. Moreover, the European Parliament has set an indicative (22 – 23 October 2012) date for it to consider MiFID and MiFIR in plenary session. Overall the proposals attempt to:

- establish a safer, more transparent, more responsible financial system in the wake of the financial crisis;
- target less regulated and ‘more opaque’ parts of the financial system e.g. OTC traded instruments in accordance with the recent G20 consensus;
- target the commodities markets, due to the increased presence of financial investors arguably leading to excessive price increases, price dislocation and volatility, and due to recent concerns about integrity in EU energy and carbon markets;
- provide for rapid changes in market structure and technological development in EU equity markets e.g. the development of high frequency trading;
- strengthen investor protection; and
- contribute to the development of a ‘single rulebook’ for EU financial markets, by minimising the discretion Member States have under EU financial services regime.

As anticipated, the proposals are extremely wide ranging and reforms are suggested to almost all elements of MiFID. Some of the most contentious areas of reform include:

- the creation of a new category of trading venue, Organised Trading Facilities (“**OTF**”) which are designed to catch dark liquidity pools – trading systems which are not subject to pre-trade transparency requirements;
- the extension of existing transparency rules to cover for example, new asset classes and instruments admitted to trading on an OTF;
- the removal of the exemption in article 2.1(k) for commodity and commodity derivatives traders who “deal on own account”;
- the requirement for certain derivatives contracts to be traded on a regulated market, MTF or OTF and subject to a clearing obligation; and

- the harmonisation of the rules applicable to third-country firms providing services in the EU.

It can be said that the increased burden on service providers may well be significant and the extent to which investors will feel the corresponding benefits considering the cost, is unknown.

17. FINANCIAL SERVICES COMPENSATION SCHEME

On 22 September 2010, the FSCS published a press release confirming that, as at 1 January 2011, the compensation limit for deposits will increase to the sterling equivalent of EUR100,000. The current limits are now £85,000 for deposits and £50,000 for investments. The increase for deposits reflects the implementation of Directive 2009/14/EC which amended the Deposit Guarantee Schemes Directive (“**DGSD**”) (94/19/EC) to increase the minimum level of deposit protection to EUR100,000.

Further rules will to effect the implementation of the DGSD. These include fast payout rules meaning many individuals and small businesses will receive compensation within seven days and all payments within 20 days.

On 16 February 2012, the European Parliament approved its position at first reading on the proposal for a recast of DGSD. The recast directive aims to set in stone, by 2017, the temporary systems put in place to guarantee up to EUR100,000 of a depositor’s money in a bank within one week.

(a) The Banking Act 2009

Part 4 of the Banking Act 2009 gives the Treasury the power to make certain changes to the FSCS, including introducing ‘pre-funding’ of the FSCS by allowing the FSCS to impose levies to build up contingency funds in advance of possible defaults by firms.

The Treasury is given the power to require the FSCS to contribute to the costs of applying the special resolution regime to banks and building societies facing financial difficulties, and to allow the FSCS to invest levies collected to build up contingency funds in the National Loans Fund. Broadly speaking, initially only firms whose activities fall within the same sub-class of business as the activity of the failed business which has given rise to the claims are liable to make contributions. There are 5 classes of firm, each of which is divided into subclasses.

The FSCS announced its annual levy for 2011/12 as £217m. On 16 June 2011, Southsea Mortgage and Investment Company Limited (Southsea) was placed into the Bank Insolvency Procedure. Under the fast payout process, the FSCS started paying compensation to depositors immediately and paid the majority of Southsea’s customers within two days. However, the £7.3m compensation required as a result of Southsea’s default was not included in the 2011/12 levy. The FSA advises that firms should use the current fee calculator based upon the £217m levy as normal but that they should calculate an additional payment of approximately £8.27m per £1m of protected deposit as at 31 December 2010 in respect of additional compensation costs for the deposit class.

On 25 July 2012, the FSA published a [consultation paper](#) on its review of the FSCS model. The proposal are consistent with the way the funding model would work following the split of the regulatory responsibilities between the Prudential Regulation Authority (“**PRA**”) and the Financial Conduct Authority (“**FCA**”). The key points proposed by the FSA are:

- to retain the current approach;
- that there should be no cross-subsidy from, to or between the PRA classes and that a retail pool should be established for FCA classes only;
- to allocate the annual management expenses levy limit (“MELL”) between PRA and FCA classes; and
- to amend the approach for determining the amount of expected compensation costs that can be included in the annual compensation costs levy and extend the forecast period from 12 to 36 months for all classes except deposits.

The FSA has invited responses to the consultation by 25 October 2012 and hopes that its proposals will come into effect on 1 April 2013.

18. COMPLAINT HANDLING

In 2010, the FSA published the findings from its review conducted into the standards of complaints handling in banks. Although the review focused on banks, the FSA is keen to emphasise that its findings are likely to apply to all regulated sectors. Overall the FSA found that almost all banks had deficiencies in their complaints handling, noting the following aspects in particular:-

- Lack of senior management involvement – “very low levels of senior management engagement” were found, which in turn meant that there were not effective complaint monitoring processes in place and complaints handling was very results-based in those banks, rather than focusing on achieving a fair outcome for complainants.
- Lack of training/competency of front-line staff where two stage processes used – in banks where complaints were initially dealt with by front-line staff, whose roles were not exclusively focused on complaint handling, there was a significant contrast with their complaints handling ability and the ability of the specialist complaints handling staff. The FSA is advocating increased training for front-line staff, so that complaints are more frequently resolved at this early stage. Good practice highlighted includes management providing support (which was updated on a regular basis) on how to deal with the most common complaints.
- Conflict of interest for complaints handlers where amount of redress linked to salary/bonus – two banks set targets for staff as to the amount of redress paid, which made complaints handlers more reluctant to pay redress to complainants. Good practice highlighted rewarded staff for resolving high volumes of complaints which achieved fair outcomes for complainants.
- Inadequate amounts of redress paid – compensation paid by banks tended not to be appropriate (including payment for inconvenience and distress), and that there were inadequate offers to undertake remedial action.
- Poor quality investigations into complaints – regular failures to obtain all relevant information relating to the complaint, including failures to communicate adequately with complainants with regard to the investigation and the outcome of the investigation.

Following this review, the banks that the FSA investigated have agreed to remedial measures to update their complaints handling procedures.

The £2.8 million fine imposed by the FSA against the Royal Bank of Scotland plc and National Westminster Bank plc on 7 January 2011 showed the FSA's willingness to take action in this sphere and its intention to ensure fundamental changes are implemented. This has been reaffirmed by the

FSA imposing a fine of £2,170,000 against UK Insurance Ltd. for the failings of Direct Line and Churchill in relation to complaint handling failings.

Complaints handling is a focus area for the FSA. Its [consultation paper 10/21](#) published in December 2010, put forward several important new proposals in this area, such as requiring firms to identify a senior individual responsible for complaints handling.

On the 27 May 2011, the FSA confirmed new complaints handling rules and an increase in the Financial Ombudsman award limit to £150,000. In [CP11/10](#), the FSA confirmed the following changes to the Dispute Resolution Complaints (DISP) sourcebook: (i) the two-stage complaints-handling process will be abolished (the complaints procedure has been abolished with effect from 1 July 2012); and (ii) firms will be required to identify a senior individual responsible for complaints handling and the FSA will set out guidance on how firms can meet the existing requirements relating to root-cause analysis, with effect from 1 September 2011 (a month later than originally expected). Further minor changes to DISP based on responses to the FSA's March 2010 publication [DP10/1](#) and in anticipation of UCITS IV took effect from 1 July 2011 in respect of UCITS IV and 1 September 2011 otherwise.

The FSA also published a report on 1 June 2011 containing its review of complaint handling in banking groups. The review found poor complaint-handling standards in most of the banks which the FSA assessed. The FSA commented that this was the result of poor governance arrangements, policies and procedures. Overall the FSA found that most banks had not embedded a culture of delivering fair outcomes for complainants, this was particularly due to a lack of senior management engagement with complaints handling and inadequate procedures and training. In addition, many front-line staff were found to be without adequate support which often resulted in incorrect decisions being made and that adherence to process was too often pursued rather than quality and fairness of response. The FSA also commented that the degree and quality of root cause analysis varied between banks.

19. INDIVIDUAL ACCOUNTABILITY

Individuals carrying out certain “controlled functions” in the UK (found in rule 10.4.5 of the FSA's Supervision Handbook (“SUP”)) require prior approval from the FSA. These “approved persons” are bound by the FSA's Statement of Principles and Code of Practice for Approved Persons (“APER”). An approved person may be found guilty of misconduct if he or she fails to comply with APER.

The FSA, in line with its “Credible Deterrence Strategy”, has recently taken enforcement action against approved persons in relation to non-compliance with APER. In the first decision (“[Pottage](#)”), Mr Pottage was fined £100,000 for breach of Principle 7 APER which requires an approved person to take reasonable steps to ensure that the business for which he or she is responsible has complied with regulatory rules and standards. Although Mr Pottage was successful on appeal to the Upper Tribunal, it must be noted that the decision was overturned on evidentiary reasons and it does not mean senior management cannot be held personally accountable.

The second decision (“[Cummings](#)”) further reinforces this fact. In Cummings, the FSA imposed the largest fine given to an individual ever recorded. Mr Cummings was fined £500,000 and banned from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm or an insurer. The FSA found Mr Cummings to have breached Principles 3 and 6 APER. Principle 3 related to HBOS's failure to take reasonable care to organise its affairs

responsibly with adequate risk management systems, whereas Principle 6 related to Mr Cummings' own failure to exercise due skill, care and diligence in managing the business. An important element to note in Cummings is that, notwithstanding the fact that the FSA found Mr Cummings to "have made significant improvements towards risk management systems", his punishment was substantial. Furthermore, although the standard of liability is not strict liability and is fault based, on the facts of Cummings, it seems as though the FSA has inadvertently applied a test of strict liability. In this regard, if faced with such action, it is advisable for authorised persons to appeal any adverse ruling made.

The FSA's message to the industry is clear; senior managers holding significant responsibility are required to take responsibility for ensuring that appropriate regard is paid to the risks associated with their businesses. Further the FSA has indicated that it wants to see remuneration incentives aligned with regulatory compliance and for market participants to actively engage in assessing risk. In light of these decisions, it is advisable for approved persons to retain all documents relating to management decisions made, and for DNO insurance policies to be reviewed in order that they afford the appropriate protection in case of FSA action.

20. REGULATION OF SHADOW BANKS

The Financial Stabilities Board ("FSB") and the European Commission have strengthened their efforts to regulate shadow banks. On 19 March 2012 the European Commission published a [green paper](#) consulting on the approach it should take towards the regulation of shadow banks. Further in April 2012 the FSB announced that it hopes to publish its policy recommendations by the end of 2012 (Strengthening the Oversight of Regulation of Shadow Banks ("[FSB April 2012 Report](#)").

Shadow banking consists of entities that provide credit and liquidity but unlike banks they do not have access to central bank funding or a safety net such as deposit insurance. The FSB has recently defined shadow banking as "credit intermediation involving entities and activities outside the regular banking system" ("[FSB April 2012 Report](#)"). Institutions such as hedge funds, money market funds and structured investment vehicles are all shadow banks.

The concerns with shadow banking are centred around the fact that these unregulated institutions perform many of the functions of a bank and are intertwined with regulated banks. The FSB has stated that it is concerned with the possible risks posed by shadow banks to the financial system, on their own and through their links with the regular banking system. In particular, short-term deposit-like funding of non-bank entities can easily lead to "runs" in the market if confidence is lost ("[FSB April 2012 Report](#)"). Further, there is also a fear of a build up of systemic risk attributed to the fact that banks often comprise part of the shadow banking credit intermediation chain or provide support to non-bank entities.

The FSB aim to focus on five specific areas:

- (i) to mitigate the spill-over effect between the regular banking system and the shadow banking system;
- (ii) to reduce the susceptibility of money market funds to "runs";
- (iii) to assess and mitigate systemic risks posed by other shadow banking entities;
- (iv) to assess and align the incentives associated with securitisation to prevent a repeat of the creation of excessive leverage in the financial system; and

- (v) to dampen risks and pro-cyclical incentives associated with secured financing contracts such as repurchase agreements, and securities lending that may exacerbate funding strains in times of “runs”.

The European Commission is currently focussing its work on the following shadow bank entities:

- special purpose entities that perform liquidity and/or maturity transformation. This includes securitisation vehicles such as asset-backed commercial paper (“ABCP”) conduits, special investment vehicles (“SIV”) and other special purpose vehicles (“SPV”);
- money market funds (“MMFs”) and other types of investment funds or products with deposit-like characteristics;
- investment funds, including exchange traded funds (“ETFs”), that provide credit or are leveraged;
- finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank; and
- insurance and reinsurance undertakings that issue or guarantee credit products.

The Commission’s consultation also sets out five key areas where it intends to undertake further work:-

- (vi) Banking regulation – the Commission is examining consolidation rules for shadow banking entities to ensure that bank-sponsored entities are appropriately consolidated for prudential purposes. Further, the Commission aims to examine ways to identify the channels of exposures, limit excessive exposure to shadow banking entities and improve the disclosure requirements for banks towards exposure to such entities.
- (vii) Asset management regulation issues – the Commission is considering the evolution of the ETF and MMF markets.
- (viii) Securities lending and repurchase agreements – the Commission is examining current practices, identifying regulatory gaps and looking at inconsistencies between jurisdictions.
- (ix) Securitisations – the Commission is reviewing whether existing provisions in EU legislation relating to securitisation have been effective in addressing shadow banking concerns. The main issues that have been identified relate to transparency, standardisation, retention and accounting periods.
- (x) General work on shadow banking entities – the Commission is undertaking additional work on other shadow banking entities to: (i) list the entities that could be covered; (ii) map the existing regulatory and supervisory regimes in place; (iii) identify gaps in those regimes; and (iv) suggest additional prudential measures for these entities, where necessary.

In this regard, it is inevitable that shadow banks will be regulated by the end of 2012, beginning of 2013.

21. INTER-BANK PAYMENT SYSTEMS

Part 5 of the Banking Act 2009 gives the Treasury the power to make a recognition order in respect of an inter-bank payment system where it is satisfied that any deficiencies in the design of such system,

or any disruption of its operation, would be likely to threaten the stability of, or confidence in, the UK financial system, or have serious consequences for business or other interests throughout the UK.

The BoE assumed responsibility for oversight of payment systems under Part 5 on 31 December 2009 and has adopted 14 principles which system operators must comply with, and which may be found [here](#). The BoE may require such operators to establish rules for the operation of their systems. The BoE's September 2009 paper explaining how it intends to fulfil its responsibilities of overseeing inter-bank payment systems may be found [here](#). Further, on 11 April 2012 the BoE published its [Payment System Oversight report](#), detailing how the BoE has implemented the statutory framework for payment systems oversight under Part 5. The competent authority for firms providing payment services under the Regulations is the FSA. The interaction between the FSA and the BoE has been clarified in a recent [Memorandum of Understanding](#).

The Treasury must revoke a recognition order where an inter-bank payment system no longer meets the requirements set out. Any person wishing to make a request to the Treasury to make a recognition order in respect of an inter-bank payment system or to make representations for the de-recognition of a recognised system should contact the Payment Systems Unit. Treasury guidance on the recognition process for inter-bank payment systems can be found [here](#).

The Treasury has launched a consultation on extending the BoE's powers under Part 5 by allowing it to disclose specified information for the purpose of, or in connection with, criminal investigations and proceedings, or for those investigations and proceedings that could result in the imposition of civil penalties. The consultation also sets out the circumstances under which the BoE may publish specified information.

The Banking Act 2009 (Inter-Bank Payment Systems) (Disclosure and Publication of Specified Information) Regulations 2010 (SI 2010/828) came into force on 9 April 2010 which:

- enable the BoE to disclose specified information with a broader range of persons and in a greater range of scenarios than is currently permitted under the Banking Act; and
- set out the circumstances in which the BoE can exercise its right to publish specified information, including when it is obliged to consult with the FSA prior to publication.

More recently, through the [Financial Services Bill 2010-12](#) (FS Bill) published on 27 January 2012, the government has made certain proposals concerning the role of HM Treasury and the BoE regarding inter-bank payment systems. The FS Bill will give the BoE responsibility for the supervision of central counterparties (“**CCPs**”) and securities settlement systems (“**SSSs**”) and will grant the BoE new powers, including an enforcement power.

22. CODE OF TAX CONDUCT

HM Revenue and Customs (“**HMRC**”) introduced a voluntary code of tax conduct for all banks operating in the UK in 2009. The code states that:

- banks should have strong governance around tax, which is integrated into their business decision making;

- they should follow the spirit of the law in addition to the letter – meaning that banks can undertake tax planning to support their business operations, but this should not be used to achieve tax results that are contrary to the intentions of Parliament; and
- HMRC and the banks should work together to encourage mutually open and transparent relationships.

Although signing up to the code is voluntary, failure to sign is taken into account by HMRC in assessing the bank's risk status and is likely to result in greater scrutiny. There is no sanction for non-compliance following signature though pressure will be put on the board to comply, and reports might be made to professional bodies when appropriate. As at the 17 October 2010, only four out of the top fifteen banks had adopted the code. Following pressure in late 2010 from the chancellor, George Osborne, HM Treasury announced on 30 November 2010 that the top fifteen banks operating in the UK have now adopted the Code of Practice on Taxation (CPT). On 26 March 2012, the HMRC published a **governance protocol** on compliance with the CPT, detailing the government process around communication and escalation procedures in any case where the HMRC has concerns about a bank's compliance with its commitments under the CPT. Further, where the HRMC has told a bank that it considers that the bank has not complied with the CPT, the bank is then expected to acknowledge this in any public statements which it makes on its operation of the Code.

23. EUROPEAN BANKING REFORM

On 22 February 2012, the EC published a **press release** announcing that Michel Barnier, European Commissioner for Internal Market and Services, has appointed the members of the high-level expert group on the structural aspects of the European banking sector.

The group's **mandate** requests that the group consider whether, in addition to ongoing regulatory reforms at EU and international level, there is a need for structural reforms of the EU banking sector. If the group concludes that further structural reform is required, it should make proposals with an objective of establishing a safe, stable and efficient banking system for consumers, the EU economy and the internal market.

The group is also asked to pay particular attention to ongoing structural reforms, including the Volcker Rule, the Dodd-Frank Act 2010 and the proposals of the Independent Commission on Banking (ICB), which the UK government has committed to implement. When developing any recommendations, the mandate specifies that the group should note the following key issues: reducing the risk of the banking system as a whole; reducing the risks posed by individual firms to the financial system; reducing moral hazard; promoting competition; and maintaining the integrity of the internal market.

The group has recently undertaken a **consultation** of the current EU banking structure and is in the midst of publishing its report (which should be published by the end of 2012).

24. UNITED KINGDOM REGULATORY REFORM

(a) Finance Act 2011

This piece of legislation received Royal Assent on 19 July 2011. The Finance Act 2011 puts in place the bank levy announced in June 2010 Budget. The bank levy rules have now been enacted as section 73 of, and Schedule 19 to, the Finance Act 2011 and the levy was applicable from 1 January 2011.

The bank levy intends to make banks contribute to a degree that reflects the risk that bank failure poses to the UK financial system and to the global economy.

The final version of the Bank Levy Manual issued by HMRC is published in the [Library section of the HMRC website](#).

(b) Financial Services Act 2010

The Financial Services Act 2010 (the “**FS Act**”) received Royal Assent in April 2010. The main changes to the regulatory regime are summarised below:-

- Objectives of the FSA – With effect from 12 October 2010, the FSA’s regulatory objective for “promoting public understanding of the financial system” was removed by the FS Act. In turn, in order to contribute to the protection and enhancement of the stability of the UK financial system, the FS Act presented the FSA with a new financial stability objective. Along with this new objective, the FSA was presented with new powers to obtain certain information or certain documents.
- Remuneration of executives – HM Treasury was given the power to make regulations for authorised firms to provide it with remuneration reports. These reports are either to be filed with the FSA of the Registrar of Companies. Moreover, HM Treasury has the power to create offences in relation to the aforementioned remuneration reports. Lastly, the FS Act imposed a duty on the FSA to make rules obliging authorised firms to operate a policy in relation to remuneration.
- Living wills - the FSA may require authorised firms to prepare and keep up to date recovery and resolution plans (i.e. so called ‘living wills’). A recovery plan would set out the proposed actions of a firm experiencing stressed conditions, such as restructuring or the scaling back of operations. Resolution plans would set out actions to be taken upon the failure of a business, or when failure is likely. Britain’s largest banks were required to present their “living wills” to the FSA in October 2010, ahead of the G20 summit in Seoul in November. On 9 August 2011 the FSA published its proposals for recovery and resolution plans in consultation paper [CP11/16](#). The FSA proposes that regular submissions of firms’ recovery and resolution plans begin from 2013.
- Disclosure of Short selling – the FSA has set out its short selling rules in its new Handbook module Financial Stability and Market Confidence Sourcebook (“**FINMAR**”) which came into force in June 2010. Holders of “significant net short positions” in UK institutions such as banks and insurers must disclose these positions. The European Short Selling Regulation has now come in to effect and has superseded many of the provisions in FINMAR. Further, inline with the Short Selling Regulation, the FSA has recently published its [guidelines](#) for making UK

notifications to obtain market maker and primary dealer exemptions under Article 17 of the Short Selling Regulations.

- Increased powers of suspension of firms and approved persons – under the FS Act, the FSA has been given the power to suspend or impose restrictions on approved persons, cancel a firm's authorisation, impose penalties on persons who perform controlled functions without approval and suspend or impose restrictions on an approved person guilty of misconduct.
- Consumer Financial Education Body (CFEB) – this body was established in April 2010 to increase public awareness of the FSA. This has the effect of replacing the, now removed, FSA regulatory objective of promoting public understanding of the financial system. Since 4 April 2011, this has now been renamed the Money Advice Service.

(c) New financial services regulatory structure

HM Treasury published a consultation paper on 17 February 2011 which builds on George Osborne's Mansion House Speech in June 2010 and reflects responses to previous consultations and reports. Following the consultation stages, on 27 January 2012, the government published the **text of the Financial Services Bill** (“**FS Bill**”). The government has set a deadline of “early 2013” for the completion of the necessary primary legislation and the transfer of powers to the new regulatory bodies. A **consolidated version**, reflecting the future amendments brought by the FS Bill, of the Financial Services and Markets Act 2000 was published by HM Treasury on 22 February 2012

Amongst other changes, the FS Bill gives responsibility for financial stability to the BoE, introduces a crisis management scheme and abolishes the FSA. Following the abolition of the FSA, three new regulatory bodies will be established: the Financial Policy Committee (“**FPC**”), the Prudential Regulation Authority (“**PRA**”) and the Financial Conduct Authority (“**FCA**”). The PRA and the FCA will take over the majority of the existing functions of the FSA. On the other hand, the FPC will not itself directly supervise firms. It will sit within the BoE and it will have the responsibility for macro-prudential regulation. It will respond to any major issues affecting economic and financial stability by directing the PRA (and, where necessary, the FCA) to take necessary action.

The main idea behind the break up of the FSA is to split the responsibility for macroeconomic and microeconomic regulation, with the ultimate aim of preventing another economic crisis.

The FS Bill will largely amend existing legislation and will make substantial changes to FSMA. Moreover, the Bank of England Act 1998 and the Banking Act 2009 will be amended. Apart from the changes aforementioned, the FS Bill intends to bring about the following changes:

- a strengthened regulatory architecture (i.e. the FPC, PRA and FCA);
- provides the authorities with powers to look beyond ‘tick-box compliance’. There is a firm intention to promote a regulatory culture that is based on expertise, judgment and proactive supervision;
- a new crisis management regime that will provide greater accountability and clarity during times of crisis. In effect, the Chancellor is provided with new powers over the BoE where the public purse is at risk; and
- in order to better protect consumers, a transfer to the FCA of the responsibility of regulating consumer credit. Upon the publication of the FS Bill, The Financial Services Consumer Panel (“**FSCP**”) welcomed this transfer. However, on 21 February 2012, the FSCP published a

Position Paper on Fiduciary Duty. This proposes the imposition of a fiduciary duty of care on the providers of financial services through the FS Bill.

The move to “twin peaks” regulation has been seen as controversial as a result of concerns of overlapping obligations and duplication for larger firms who will be subject to the oversight of both bodies.

An “interim FPC” was set up by the government in February 2011. This was established with the intention of undertaking, as far as possible, the macro-prudential role of the future FPC. It also carries out preparatory work and analysis in advance of the creation of the permanent FPC. A key component of this work and analysis is conducting preparatory analysis into potential macro-prudential tools. In December 2011, the BoE published a **discussion paper** on the potential contents of the FPC’s macro-prudential toolkit. Following a meeting on 16 March 2012, the “interim FPC” has published a **report** advising the government as to the powers the statutory FPC should have once it is established.

The future co-ordination between the new authorities has also been subject to discussion. It is clear that the new structure will necessitate close co-operation and co-ordination between the new regulatory bodies. In January 2012, due to the large number of potential overlaps (especially in the realm of dual regulated firms); the PRA and the FCA published a **draft version of the Memorandum of Understanding** on the aspect of co-ordination. Moreover, in the same month, HM Treasury published a **draft version of the international organisations Memorandum of Understanding** in relation to international representation of the United Kingdom and a **draft Memorandum of Understanding on crisis management**.

In a speech in February 2012, Hector Sants stated that the next major milestone in the regulatory reform was the implementation of a “twin-peaks” model operating from 2 April 2012 within the FSA.

(d) Changes to the existing FSA Handbook to accommodate the new financial regulatory structure

The first of the Consultation Papers (“**CP**”) on the changes to the existing FSA Handbook relating to the new Financial Services Bill 2012 was published 12 September 2012. The intention is for the final changes to be made by the new regulators, as part of the creation of the new FCA and PRA rulebooks. This will take place once the Prudential Regulation Authority (“**PRA**”) and the Financial Conduct Authority (“**FCA**”) acquire their legal powers. The CP is part of the work to split the FSA Handbook between the FCA and PRA to form two new Handbooks and to align the new rulebooks with the future objectives and functions of the PRA and FCA. However, most provisions in the FSA Handbook will be incorporated into both new Handbooks. The approach is to ensure a safe transition for firms and the new regulators as the new regime is introduced.

The proposed changes shall be highlighted below.

General Provisions and Definitions (GEN 2):

- The CP explains the changes to the definitions and the prescribed wording that firms must use. Of particular importance is the definition of ‘appropriate regulator’, this will mean the FCA when referring to the FCA Handbook and the PRA when referring to the PRA Handbook.

Regulatory disclosure and the use of the regulators' logos (GEN 4/5):

- Non-EEA/overseas firms' disclosure requirements will be amended. Non-EEA firms will now be required to disclose the identity of the regulator in the jurisdiction of that firm's registered or head office. Regulated firms will also have to disclose information to the effect that they are subject to limited regulation by the PRA and that such details are available from the branch on request.
- Withdrawal of the general right of firms to use the future FCA or PRA logos in their communications. Firms will have six months to make the necessary changes from the legal cutover. The new system is at the current time going through the House of Lords with the aim of receiving Royal Assent by the end of 2012, and for the new system to be operational in early 2013.

Skilled Persons (SUP 5):

- Changes to the FCA and PRA's Skilled Persons power, made to reflect the changes under the 2012 Bill such as:
 - extending the FCA powers to allow the use of Skilled Persons reports for recognised exchanges; and
 - giving the FCA and PRA the powers to appoint and contract directly with the Skilled Person.

Applications to vary and cancel Part IV permissions and requirements (SUP 6):

- Changes to the way in which a firm must apply to vary or cancel its authorisation or to vary or cancel requirements imposed by the regulator. This is reflected in Part 4A, a new part of FSMA which replaces Part IV section of FSMA.
- FSA authorised firms will now have to apply to the appropriate regulator, in order to vary or cancel any permission given to them. From the legal cutover, dual-regulated firms will have to apply to the PRA to vary or cancel its Part 4A permission. While, FCA-only regulated firms will have to apply to the FCA to vary or cancel its Part 4A permission.
- If a firm has applied to vary its authorisation, the FCA and PRA will be able to impose new requirements on the firm.
- Applications to vary authorisation continue to cover: a) adding a new regulated activity that has permission; b) removing a regulated activity; and c) varying the description of a regulated activity.
- The FCA and PRA also have powers to cancel requirements on firms.

Waiver and modification rules (SUP 8):

- Changes to the way firms will apply for waivers of rules or modifications of rules. Significantly, the PRA can waive or modify rules contained in the PRA Handbook as it applies to them to dual regulated and FCA-only regulated firms. Further, the preferred method for submitting applications for the modification or waiver of rules will be electronic, rather than via the ONA system.
- Neither regulator may waive or modify rules, unless it is satisfied that the direction would not adversely affect the advancement of the PRA objectives, or in the case of the FCA its operational objectives.

Controllers and close links (SUP 11):

- Changes to various reporting and notification requirements. Notably, if a person decides to acquire, increase control over, reduce or cease to have control over a UK-authorized person it must notify the appropriate regulator. In the case of a dual regulated firm the PRA must be notified, while in the case of a FCA-only firm, notifications must be made to the FCA.

Passporting (SUP 13):

- Due to the proposed changes, firms will need to notify the appropriate regulator if they wish to exercise a right under an EU directive to passport out of the UK or into the UK. The passporting notification forms to be used will be updated and accessible online.

Transfers of business (SUP 8):

- Changes to the process for transfers of insurance businesses such as requirements that applicants should discuss initial proposals with their usual supervisory contacts and provide initial information to the PRA (who will lead the process). Further amendments will also be covered by a proposed Memorandum of Understanding between the PRA and FCA.

The FSA will most likely publish further consultation papers in the coming months on the proposed regulatory reform and its changes to the FSA handbook. This will provide us with more guidance on the impact of the new Financial Services Bill.

(e) Independent Commission on Banking

In addition to the reform highlighted above, in June 2010 George Osborne also announced the establishment of the Independent Commission on Banking (the “**ICB**”), to be chaired by Sir John Vickers. The ICB’s job has been to formulate policy recommendations, with the following scope and objectives:

- reducing systematic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- mitigating moral hazard in the banking system;
- reducing both the likelihood and impact of firm failure; and
- promoting competition in both retail and investment banking with a view to ensuring that the needs of banks’ customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.

On 12 September 2011, the ICB published its **Final Report** in which it sets out its recommendations for banking reform in the UK. In accordance with the Terms of Reference, the Final Report identifies two broad areas of reform: (i) financial stability; and (ii) competition.

To improve financial stability in the banking sector, the ICB recommends the ring-fencing of retail banking services and that banks should be required to hold more capital relative to their assets, in order to increase their loss-absorbency. More specifically it suggests that large ring-fenced banks should be made to hold at least 10% equity against their risk-weighted assets - a stricter capital maintenance requirement than any imposed under Basel III.

The ICB also emphasises the need to promote competition in UK banking in the Final Report. It recommends various ways in which to enhance customer choice, for example through the introduction of an effective account switching service.

The ICB recommends that the reforms be adopted as soon as possible, but proposes a full implementation by 2019, in line with Basel III.

HM Treasury and the Department for Business, Innovation & Skills, on 19 December 2011, published the government's **response** to the ICB. In relation to the first area of reform, competition, the government has stated that it intends to provide the new FCA with strengthened competition objectives.

In June 2012 the HM Treasury and BIS published a white paper ("**June 2012 white paper**") in which the government announced the oncoming Banking Reform Bill which will introduce measures implementing the Independent Commission on Banking's ("ICB") recommendations on ring-fencing and depositor preference. The Banking Reform Bill will be brought before Parliament in January 2013, with the legislation completed by the end of May 2015.

One of the foremost changes proposed by the Bill is to ensure for a compulsory ring-fencing of retail and small and medium-sized deposit-taking businesses ("SME") in separate, financially independent legal entities subject to higher prudential requirements. The aim of this proposed ring-fencing is to protect the provision of vital banking services. The ICB has recommended the following classifications as to the types of work different banking entities may undertake (which the government has adopted in the June 2012 white paper):

- mandated services – these are services that can only be performed by a ring-fenced bank (e.g. taking deposits from certain individuals and SMEs);
- prohibited services – these are services that a ring-fenced bank would be prohibited from undertaking (e.g. dealing with investments as principle);
- permitted services – these are services that are not mandated or prohibited services and as such can be carried out by both types of entities; and
- ancillary activities – these are activities that are necessary for the efficient provision of mandated services and permitted services and thus again can be carried out by both entities (e.g. employing staff and owning, or procuring the necessary operational structure).

Further, in the June 2012 white paper the government has stated that it intends to ensure that a ring-fenced bank treats, and is treated by, other members of its group as a third party, in order that its stability is not dependant on the financial health of the rest of its group. The following aspects of separation are most relevant:

- liquidity and capital requirements – ring fenced banks should meet capital and liquidity on a standalone basis. If there are a number of ring fenced banks in a group, the regulator may apply those requirements as a sub-consolidated group of ring-fenced banks;
- limits on intra-group exposures – limits on intra-group exposures will be treated as though they are between third parties. This is to ensure the independence of the ring-fenced entities;
- intra-group funding – the government has indicated that it would like the regulator to impose limits on intra-group funding; and
- governance of the ring-fenced bank – at least half of the board of a ring-fenced bank (excluding the Chair) must be independent.

Although it must be noted that these recommendations are still at a preliminary stage, the government has clearly outlined its commitment to ensure that retail banking activities are ring-fenced and it seems only a matter of time before these proposals are made binding.

25. EUROPEAN REGULATORY REFORM

From 1 January 2011, the reformed EU financial services supervisory framework, came in to effect. It is known as the European System of Financial Supervision and consists of:

- the European Systemic Risk Board (“**ESRB**”);
- the European Supervisory Agencies (“**ESAs**”) which consists of (i) the European Banking Authority (“**EBA**”); (ii) the European Insurance and Occupational Pensions Authority (“**EIOPA**”); and (iii) the European Securities and Markets Authority (“**ESMA**”);
- the 27 EU member state national supervisors; and
- the Joint Committee of the ESAs.

The three new ESAs, together with the ESRB, have extensive new powers including the ability to impose directly binding technical standards. The ESAs will coordinate the work of national regulators, and they will also be able to mediate and arbitrate in any disagreements between national regulators. Of the three, the powers of ESMA which has, from 1 July 2011, direct and exclusive supervisory powers over credit rating agencies and is also to be given supervisory power over trade repositories under the proposed regulation on OTC derivatives markets, appear the most wide ranging and direct.

In terms of these institutions’ significance, Hector Sants, in his speech on the future of insurance regulation has gone so far as to say: "Going forward, the FSA and its successor authorities will thus essentially be a supervisory arm of an EU policy setting body." As such, knowledge of the EU regulatory structure and reforms is important to the compliance arms of UK firms.

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