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Insight

Financial Markets Disputes and Regulatory Update

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In this edition of the Financial Markets Disputes and Regulatory Update, we have considered the key financial markets cases, and banking-related regulatory action, from the first half of 2015, and distilled them into a list of points which are worth taking away. We hope this will provide readers with a digestible series of considerations to feed into ongoing work as the year moves on.

Contents

What is worth remembering from the first half of 2015? 4

Judgments - so far this year... 6

- Jurisdiction for claims in relation to bearer bonds 6
- Exercise of contractual rights by purchaser of notes in the secondary market 6
- Claim for misrepresentation against issuer by purchaser of notes in the secondary market 7
- Role of trustee in Argentine bond litigation 8
- Right of set-off under the ISDA Master Agreement 8
- Calculation of "Loss" under the ISDA Master Agreement 9
- Entitlement to payment premium after transfer - LMA standard terms 10
- When a bank is on constructive notice of wrongdoing 10
- Satisfaction of delivery obligations under repo agreement 11

Regulatory developments 13

- Senior Managers regime 13
- *Finalised guidance 15/1* 13
- Holmcroft Properties Limited 14
- Fall-out from the London Whale 14
- Final notices 15
- Other developments 17

What is worth remembering from the first half of 2015?

Court decisions / impacts

It has been a busy six months in the courts for issuers of notes. Argentine bond litigation returned for a brief visit to the English court, in the wake of holdout creditors' well-publicised victory in the Southern District of New York, but the more interesting cases involve the liability of issuers to purchasers of notes in the secondary market. Two cases considered issues of jurisdiction, and another considered liability under the Misrepresentation Act 1967. Taken together, they leave a rather uncertain picture in relation to this area, and the success of a misrepresentation claim suggests that issuers should be particularly alive to the possibility of more claims for misrepresentation in the future.

Separately, the courts considered the interpretation of provisions in standard form LMA and ISDA documentation, and returned to the ever-vexed question of when banks are on constructive notice of the proprietary interests of others in money or assets they hold. We consider these judgments below.

Regulatory developments

In the regulatory sphere, the FCA has not been resting on its laurels (which were looking somewhat tattered after a report by the Treasury Select Committee into its handling of press briefings in relation to its 2014-15 Business Plan). Issues relating to the introduction of the Senior Managers regime have been dominant, but the first quarter of this year has seen the publication of various other statements by the FCA and the PRA including in respect of retail investment advice and remuneration. There have also been a number of final notices, and it is clear from some of their content that the FCA will expect firms to pay close attention to the detail of those documents as well.

What to watch out for…

Litigation

Claims involving a LIBOR element are likely to continue to advance. Deutsche Bank is facing claims by Unitech. The litigation between Property Alliance Group and RBS, which involves similar issues to the Deutsche Bank case, is also being followed by the market. It also remains to be seen whether the comparatively recent round of fines for manipulation of forex benchmarks will trigger a similar rash of claims.

The last few years have seen a number of cases involving local authorities or quasi-public bodies in various European countries which have lost significant amounts as a result of entering into complex derivative contracts. It is likely that the court will consider more of these cases in the second half of this year.

Regulatory and other developments

The next six months are likely to be as busy as the first half of this year, and there are some key publications on which much attention will be focused. First, the FCA and the PRA have yet to publish their full final rules and guidance in relation to the new Senior Managers regime, as well as the certification regime and conduct rules. It is likely that firms are still lobbying hard for the changes which are most important to them, and it remains to be seen whether any further substantive changes are made. One issue to watch out for is a possible consultation on extending the certification regime to cover wholesale traders. The regulators have also indicated that they are looking into the issue of how they may reduce the reporting burden on firms in respect of notifying breaches of conduct rules.

The report of the Fair and Effective Markets Review was published on 10 June 2015 and it appears likely to have widespread ramifications. We will consider FEMR's report in the next edition of Financial Markets Disputes and Regulatory Update.

The outcome of the judicial review proceedings brought by Holmcroft Properties Limited (referred to on page 14) may not be known this year, but it raises the interesting question of whether a skilled person

appointed by a firm under section166 of FSMA is amenable to judicial review. Some commentators also point to an increased rate of direct appointments of skilled persons by the FCA over the last quarter.

The FCA's Business Plan sets out its plans for market studies and thematic work, and indicates that it will be conducting reviews into areas including culture, the role of appointed representatives, inducements and conflicts of interest, investment and corporate banking, and conflicts of interest in dark pools. This gives the FCA a long to-do list, and many items on it are likely to generate significant interest. The FCA will also be starting preparations for the implementation of reforms to EU financial services regulation, including MiFID II and the new market abuse regime.

A review of the FCA's penalties regime is also expected. Martin Wheatley has recently defended the success of high fines in promoting better culture within firms, so it appears that the FCA will be averse to reducing them any time soon. The recent imposition of record fines on both firms (Barclays) and individuals (Stewart Ford) would seem to confirm that message.

The Consumer Rights Act 2015 may require some careful consideration by financial services firms now that it has been enacted. The FCA has already indicated that it will consider the area of unfair contract terms in light of Part 2 of the new Act, and firms may wish to keep an eye on the content of the Act in relation to provision of services as well.

Judgments - so far this year...

Jurisdiction for claims in relation to bearer bonds

Kolassa v. Barclays Bank plc C375/13

This was a judgment of the European Court of Justice (ECJ). Mr Kolassa, who is domiciled in Austria, invested in certificates issued by Barclays in the form of bearer bonds. Barclays produced a prospectus in relation to the certificates, which was published in Austria. The certificates were then issued to institutional investors including DAB Bank, and sold to an Austrian subsidiary, which in turn sold an interest in the certificates on to Mr Kolassa. The certificates were, at all times, owned by the banks. The value of the certificates was directly referable to the performance of a portfolio, and as a result of its poor performance, the certificates lost the entirety of their value. Mr Kolassa sued Barclays in the Austrian courts. Barclays disputed both the underlying claim and the jurisdiction of the Austrian court, on which point the court made a reference to the ECJ.

Article 5 of the Regulation states that: "A person domiciled in a Member State may, in another Member State, be sued: 1. (a) in matters relating to a contract, in the courts for the place of performance of the obligation in question; ... 3. in matters relating to tort, delict or quasi-delict, in the courts for the place where the harmful event occurred or may occur". However, under Articles 15 and 16, a consumer acting "for a purpose which can be regarded as being outside his trade or profession" can start proceedings either in the home court of the other party, or in his own home court (in this case the courts of Austria), if certain conditions are met. In most cases, such conditions include the consumer having entered into a contract with a professional counterparty.

The ECJ concluded that:

1. the provisions of Article 15 did not apply in this case. Because the certificates were in bearer form, and Mr Kolassa was never the bearer, the ECJ held that he had not entered into a contract with Barclays, and that Article 15 could not, therefore, be invoked;

2. in order for Article 5(1) to be used in order to found jurisdiction, there did not need to be a contract subsisting between the issuer of and the investor in the certificates, but the issuer did need to have freely consented to some legal obligation to that investor. This would be a matter for national courts to consider, but in the context of this case, the ECJ held that Barclays had not assumed obligations to Mr Kolassa as a purchaser in the secondary market; and

3. as Austria was the place where Mr Kolassa had suffered loss, the Austrian court had jurisdiction to hear his claims in relation to Barclays's provision of misleading information in its prospectus under Article 5(3), provided such claims could not be characterised as arising out of a contract.

It is likely that the last of these three conclusions will provide some further scope for argument in specific cases, but, in general, the judgment should be reassuring for issuers. Had the decision been otherwise, they could have faced numerous (and potentially conflicting) judgments in the courts of different European states.

Exercise of contractual rights by purchaser of notes in the secondary market

Secure Capital SA v. Credit Suisse AG [2015] EWHC 388 (Comm)

Credit Suisse's Nassau office issued various notes (governed by English law, and treated collectively for present purposes) which were linked to life insurance policies, such that the amount payable under them depended on the mortality of a set of "reference lives". Credit Suisse agreed in the terms applicable to the notes that it had taken reasonable care to ensure that information in the pricing supplements was accurate,

and that there were no material facts the omission of which would make the statements misleading. Secure Capital alleged that Credit Suisse had breached those terms by failing to disclose an anticipated change to the calculation of life expectancy of the reference lives.

The notes were in bearer form, and held by BNY Mellon, which was the bearer of the notes, as common depositary for Clearstream. Subsequent transactions took place by way of book entries by members of Clearstream, who had recourse only against Clearstream in relation to non-payment. Secure Capital held the notes through such a member, RBS Global Banking (Luxembourg) SA (RBSL).

By the provisions of Luxembourg law, the owner of assets in a Clearstream account (here Secure Capital) has an intangible right in rem to securities of the same type (and the rights attaching to them) in the account of the account holder (here RBSL). Such right is only exercisable against the account holder. The same law provides that, if the account holder produces a certificate attesting to the owner's holding, the owner can exercise any corporate rights provided for in the securities, or rights attaching to the holding of the securities linked to the possession of the securities. In this case, RBSL had provided Secure Capital with such a certificate, and Secure Capital sought to rely on this provision of Luxembourg law to sue Credit Suisse directly in relation to the allegedly misleading content of the pricing supplements. Credit Suisse applied for summary judgment, alternatively to strike out the claim.

Secure Capital's position was that it was entitled in its own name, by operation of the Luxembourg law, to assert the same rights as the bearer of the notes. In making this assertion, it had to convince the court that the law of Luxembourg was the appropriate governing law, notwithstanding that the notes were governed by English law. The judge said that: "It is artificial to seek to treat the issue as being who is entitled to be the holder of the Notes. This is not a case where there is a dispute between two parties as to who is entitled to be the holder. It is accepted that BNYM is the holder. The argument is that Secure Capital is entitled to be treated as an additional holder. It is also artificial to seek to divorce that question from the rights which Secure Capital is seeking to enforce which are clearly (and admittedly) contractual rights."

On that basis, he held that the Luxembourg law had no application in this case, and that it could not, in any case, create new rights in an English law contract. In deciding the application in Credit Suisse's favour, the judge noted in some detail its argument (and the authorities supporting it) that: "any other conclusion would fly in the face of market practice and the unanimous views of the commentators relating to intermediated securities, which, for good reason, is to the effect that all rights to sue the issuer under a bearer note are held and exercisable only by the bearer, not an intermediary and certainly not the ultimate investor".

This judgment makes it clear that purchasers of notes in the secondary market will face genuine obstacles in enforcing their terms if the notes are issued in the same way as those in this case. This should not be any great surprise, given the contractual terms applicable in this (and other) cases, but it may be that this is not an issue which has previously received much attention.

Claim for misrepresentation against issuer by purchaser of notes in the secondary market

Taberna Europe CDO II plc v. Selskabet AF1. (in bankruptcy) [2015] EWHC 871 (Comm)

Another day, another judge, different facts and a completely different conclusion. The judgment of Eder J, handed down a month after that of Hamblen J in the Credit Suisse case, also related to a case where a purchaser of notes in the secondary market alleged that relevant matters had been misrepresented to it by the issuer, the failed Danish bank Roskilde. The operative misrepresentations had been made, not in the documents pursuant to which the notes were issued, but in other published documents of Roskilde, in relation to its business.

However, in summary, Taberna asserted its claim against Roskilde under section 2(1) of the Misrepresentation Act 1967, which provides that: "Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true" (emphasis added).

Roskilde argued that section 2(1) of the Act had no application in this case, because of the words underlined above. Taberna had bought the notes from Deutsche Bank, with which it had conducted some pre-sale negotiations. Any representations allegedly made by Roskilde had induced that contract, not a contract between Roskilde and Taberna, and it was the Deutsche Bank/Taberna contract that was the cause of Taberna's loss.

The judge found that section 2(1) applied notwithstanding that Taberna had bought the notes from Deutsche Bank, not Roskilde. Crucially (and curiously) the judge noted Roskilde's admission in this regard that Taberna's purchase of the notes had

created some form of contractual relationship between Roskilde and Taberna. The judgment does not indicate the form of the notes issued by Roskilde, but were they issued in bearer form, this admission would seem at odds with the views of the courts in both the cases referred to above. We understand that permission to appeal is currently being sought.

Role of trustee in Argentine bond litigation

Knighthead Master Fund LP and others v. Bank of New York Mellon and another [2015] EWHC 270 (Ch)

In 2005 and 2010, Argentina exchanged existing defaulted bonds for new ones, at a substantial discount. Its litigation with those "Holdout Creditors" who did not participate in the exchange has been long running and well publicised. However, the applicants in this case were the holders of euro-denominated bonds issued pursuant to the exchange, and governed by English law. The defendant, Bank of New York Mellon, is the trustee of the securities which comprise the exchange. The role of BNY Mellon as trustee of these bonds is also governed by English law.

The Holdout Creditors succeeded, in 2012, in persuading the District Court in the Southern District of New York to grant an injunction. The injunction was premised on the court's decision that a *pari passu* clause in Argentina's Fiscal Agency Agreement (pursuant to which the notes held by the Holdout Creditors were issued) meant that Argentina could not pay its exchange creditors without paying the Holdout Creditors rateably.

In 2014, in accordance with the terms of the exchange, Argentina made a payment to the account of BNY Mellon with the Argentine Central Bank in Buenos Aires for onward payment to the exchange noteholders (including the applicants) through Clearstream and Euroclear. The court in New York agreed that this payment was made in breach of the injunction referred to above, and BNY Mellon was ordered to retain the funds and not deal with them pending further order of the court. The court declared that BNY Mellon would incur no liability in doing so.

As set out above, the euro-denominated exchange bonds and BNY Mellon's role in relation to them were governed by English law. On that basis, neither the contractual obligations nor the payment mechanisms through which they were to be satisfied had any connection with the US, save that BNY Mellon was itself subject to the jurisdiction of the New York court, and obliged to abide by its orders. Some holders of these bonds, who found that the New York court had a longer reach than might usually be expected to be the case, applied to the English court for declarations that: (1) the money paid to BNY Mellon in Argentina for onward transmission to the euro-denominated exchange noteholders was held by it on trust for such noteholders, and did not belong to Argentina; and (2) the obligations of BNY Mellon as trustee under English law were unaffected by the orders of the court in New York.

The judge hearing the application made the first declaration sought. He took the view that to do so did not intrude on matters being considered by the court in New York, but it was appropriate to say that, as a matter of English law, the orders made in New York did not grant either Argentina or the Holdout Creditors any proprietary interest in the funds held on trust by BNY Mellon. He declined, however, to make the second declaration, holding that as (necessarily) worded, it would have the effect of saying that BNY Mellon would continue to be liable to the noteholders for its failure to pay, unless the New York injunction provided it with a defence. He did not consider that it served any useful purpose for the court to make a declaration to that effect.

Right of set-off under the ISDA Master Agreement

MHB-Bank AG v. Shanpark Ltd; MHB-Bank AG v. Vendart Ltd and another [2015] EWHC 408 (Comm)

In this case, Irish Bank Resolution Corporation (previously Anglo-Irish Bank) (the Bank) assigned to MHB-Bank (MHB) the right to payment of early termination amounts payable pursuant to two interest rate swaps concluded pursuant to ISDA Master Agreements between the Bank and the Defendants (referred to collectively below as "Shanpark"). While the judgment does not say so specifically, it appears that the 2002 Master Agreement was used. Shanpark said that:

1. the swaps had been mis-sold by the Bank, and that its claim in respect of such mis-selling was capable of founding a set-off for the purposes of clauses 2(c) and 6(f) of the ISDA Master Agreements; and

2. the Bank had already exercised a contractual right of set-off available to it by the terms of a facility agreement, and that MHB could be in no better a position than its assignor.

MHB applied for summary judgment.

The judge agreed that clause 2(c) of the ISDA Master Agreement did not apply to payments due on early termination. The clause referred to amounts which would be payable on any date in the same currency and in respect of the same transaction, whereas payments due on early termination represented (or could represent) a number of transactions. In addition, damages in respect of the mis-selling claim could only become payable once a court ordered that they be paid.

In relation to clause 6(f), the judge held that Shanpark was unable to rely on it in any event, because of a

provision in the facility agreement restricting its right to claim set-off. However, the judge considered clause 6(f) and concluded that references in it to a "defaulting party" only applied where the Master Agreement had been terminated for an event of default. The Master Agreement relied on this having happened in order for the Defaulting Party to be identified: the judge noted that there could only ever be one such party, despite the fact that both parties might be responsible for events of default.

In this case, while the Bank had been in default for some time, Shanpark had not served notice terminating for the Bank's event of default. The Master Agreement had, instead, terminated on Shanpark's repayment of the facility agreement, which was an early termination event. The Bank's default was therefore irrelevant for the purposes of clause 6(f). However, the judge went on to find that, where set-off was available under clause 6(f), it would include unascertained claims for breach of contract, as well as sums payable under a contract.

This judgment provides useful clarification of the set-off provisions in the ISDA Master Agreement. It also underscores the importance of thinking very carefully about whether or not a party should declare an event of default when it is in a position to do so.

Calculation of "Loss" under the ISDA Master Agreement

Fondazione Ensarco v. Lehman Brothers Finance SA and another [2015] EWHC 1307 (Ch)

Ensarco was an Italian pension fund, which entered into an arrangement marketed by Lehman in order to gain exposure to hedge funds, while protecting the principal sum invested. It purchased €780,470,000 of secured notes from ARIC, a special purpose vehicle incorporated in the Cayman Islands. ARIC used the money to buy shares in Balco, which in turn invested the money chiefly in funds of funds. In order to protect the capital, ARIC bought a put option from Lehman Brothers Finance SA (LBF), governed by the terms of a 1992 ISDA Master Agreement (the Option). The Option gave ARIC the right to put its shares in Balco on LBF in 2023, for a price which would be equal to the shortfall between €780,470,000 and the amount which would be received by ARIC on redemption of the shares.

Lehman's insolvency in September 2008 led to the automatic early termination of the Option. Ensarco moved to put in place replacement capital protection, which it did through Credit Suisse in May 2009 (the CS Option). The CS Option had a maturity of 2039 (rather than 2023), and premium payments were structured differently.

The dispute related to the amount payable to ARIC on early termination of the Option, which was to be determined using the Loss method in the ISDA Master Agreement. The definition says (*inter alia*) that: (a) Loss is to be reasonably determined by the calculating party in good faith; (b) a party will determine Loss as of the earliest reasonably practicable date after the early termination date; and (c) a party may (but need not) determine Loss by reference to quotations.

ARIC (which assigned its claim to Ensarco) served notice in September 2009 seeking US$61.5 million, being (in summary) the difference between the premiums it was obliged to pay under the CS Option as compared with the Option.

LBF accepted that Ensarco was entitled to base its calculation of Loss on the cost of a replacement transaction, but alleged that: (a) it could have obtained a quotation for a replacement transaction shortly after 15 September 2008, and in any event much sooner than May 2009; (b) the CS Option was on such different terms that it was not properly comparable; and (c) Loss had not been determined as at the earliest reasonably practicable date, in that notice of the amount claimed had not been provided until September 2009.

The judge did not agree that the market was such that Ensarco could have secured a replacement for the Option materially earlier than it did. He also found that the transaction (in which Lehman entities were involved in a number of capacities) required restructuring before the Option could be replaced, and that (in effect) the process inevitably took some time. The judge noted that "as soon as practicable" did not mean the same thing as "as soon as possible" and required a consideration of all the circumstances.

He also disagreed that the CS Option was too different from the Option to be termed a "replacement transaction". He held that the longer term had not been shown to have made any difference to the cost of the premium, and might in fact have driven it down. He also rejected an argument to the effect that a put option from Credit Suisse was qualitatively better than one from Lehman, because of Credit Suisse's higher credit rating. He held that the point for focus was securing the economic equivalent of the payment which would have been made under the terminated transaction, not the prospects of performance by the other party.

The judge accepted that the notice setting out the early termination amount (delivered in September 2009) could have been delivered much sooner, but found that this did not affect the validity of the calculation of Loss itself.

Entitlement to payment premium after transfer – LMA standard terms

Tael One Partners v. Morgan Stanley [2015] UKSC 12

Tael assigned its rights in respect of part of its lending under a loan agreement incorporating LMA terms for par trade transactions (now superseded) to Morgan Stanley. Morgan Stanley then transferred its participation to Spinnaker. The loan was subsequently repaid in full together with a payment premium. Tael and Spinnaker received a share of the payment premium, in respect of the participations they held at the time of repayment. Morgan Stanley, having no outstanding participation, received nothing. Tael then claimed from Morgan Stanley a proportion of the payment premium referable to the period before the transfer.

The provisions of the facility agreement were complex, and provided that the total return to each participating lender depended on a number of factors. Clause 11.9 of the LMA terms provided that:

"Unless these Conditions otherwise provide ...

(a) any interest or fees (other than PIK Interest) which are payable under the Credit Agreement in respect of the Purchased Assets and which are expressed to accrue by reference to the lapse of time shall, to the extent they accrue in respect of the period before (and not including) the Settlement Date, be for the account of the Seller and, to the extent they accrue in respect of the period after (and including) the Settlement Date, be for the account of the Buyer; and

(b) all other fees shall, to the extent attributable to the Purchased Assets and payable after the Trade Date, be for the account of the Buyer."

The Supreme Court rejected Tael's argument that the payment premium under the facility agreement was "expressed to accrue by reference to the lapse of time". It held that the fact that the payment premium was calculated by reference to the lapse of time did not mean that it accrued in that way. The payment premium in fact accrued on the occurrence of a number of defined events, including repayment and prepayment. On that basis, Morgan Stanley was not obliged to account for the payment premium to Tael.

The Supreme Court also rejected the Court of Appeal's conclusion that clause 11.9 was effectively redundant, on the basis that it did little that was not already done by clause 11.2 or 11.3. The Supreme Court found that the earlier parts of clause 11 related to fees and interest not falling within clause 11.9, and that all parts of the clause had to operate together.

When a bank is on constructive notice of wrongdoing

Papadimitriou v. Crédit Agricole Corporation and Investment Bank [2015] UKPC 13

In this case, the Privy Council considered whether the defendant bank had successfully shown that it did not have constructive notice of the claimant's proprietary right to money transferred to it. The judgment considers, in particular, the circumstances in which a bank is obliged to investigate a transaction in order to avoid being fixed with such notice.

The funds which were the subject of the litigation were the proceeds of sale of a collection of furniture belonging to the deceased parents of the claimant. The collection was sold without the family's knowledge by the partner of the claimant's brother, who had also died, and the proceeds of sale were laundered through a number of entities incorporated in different jurisdictions before being transferred to the bank.

The bank, based in Gibraltar, received the funds as guarantee for a loan extended by its London branch to refinance borrowings of a company owned by the seller of the collection.

The Privy Council set out three situations in which a bank would have notice of another's proprietary right to funds it received, and in which it would therefore not be able to establish that it was a bona fide purchaser for value of the funds. Those situations are where the bank:

1. has actual notice, in that it in fact appreciates the probability that another person has a proprietary right;
2. ought to have understood, on the basis of the facts already available to it, that such a right existed (constructive notice); and
3. should have made inquiries or sought advice which would have revealed the probable existence of such a right (a further species of constructive notice).

The Privy Council was primarily concerned with the third category of cases. Delivering the lead judgment, Lord Clarke said that "The bank must make inquiries if there is a serious possibility of a third party having such a right, or put another way, if the facts known to the bank would give a reasonable banker in the position of the particular banker serious cause to question the propriety of the transaction". Lord Sumption added that "There must be something which the defendant actually knows (or would actually know if he had a reasonable appreciation of the meaning of the information in his hands) which calls for inquiry". In this case, the unnecessary complexity of the structure of the transaction, and interposition of different layers of corporate entities, was sufficient to mean that the bank should have made further inquiries.

Satisfaction of delivery obligations under repo agreement

(1) Mercuria Energy Trading Pte; and (2) Mercuria Energy Group Ltd. v. (1) Citibank NA; and (2) Citigroup Global Markets Ltd [2015] EWHC 1481 (Comm)

In May 2013, the Citi entities which were the defendants to these proceedings entered into Master Agreements relating to repo transactions they were to conclude with Mercuria. The nature of the transactions to be concluded (each pursuant to the terms of a Sale Confirmation and a Forward Sale Confirmation) was that Mercuria would sell Citi a quantity of metal stored in three warehouses in China, and Citi would sell back equivalent metal (in reality the same metal, which would never leave the warehouse) at a future date and at a higher price (the Forward Sale). While the purpose of these transactions was for Citi to provide finance to Mercuria, ownership of the metal was stated to pass to Citi.

In late May 2014, reports emerged of a fraud at two of the warehouses, whereby the same warehouse receipts had been tendered in transactions with a number of banks, such that (in effect) the same metal had been sold or charged more than once. The scale of the fraud is under investigation in China and has yet to be made known.

The Master Agreements provided that, if any storage facility ceased to be satisfactory, Citi could serve a Bring Forward Event Notice (called a "BFE Notice" in the judgment) which would have the effect of accelerating the Forward Sale. Citi was then entitled to receive payment from Mercuria, prior to delivering the metal back to it. Citi served BFE Notices in June 2014. In July 2014, Mercuria served notices stating that there had been a Termination Event as defined in the Master Agreements, in that the discovery of fraud at the warehouses had a material adverse effect on Citi's ability to perform its obligations. On that basis, the Master Agreements stated that Mercuria was not obliged to make any payment until the metal was delivered to it. This Citi purported to do by delivering its warehouse receipts to Mercuria, endorsed in blank. The warehouse operators did not attorn to Mercuria (and were not asked by Citi to do so), and Citi did not issue release instructions to them.

The issues between the parties were (in summary): (a) as to whether this amounted to valid delivery (and, if not, whether Citi could instead deliver the metal pursuant to the terms of the Master Agreements by assigning rights to Mercuria); and (b) whether the BFE Notices were valid, and survived service of Mercuria's termination notices.

The judge held that Citi had not delivered the metal. Citi accepted that the Sale of Goods Act 1979 (the Act) applied to the transactions, and that, under the provisions of section 29(4) of the Act, delivery could not be effected unless a title document was passed to Mercuria (the warehouse receipts were not title documents) or the warehouse operators attorned to Mercuria that they held the metal for it. However, Citi argued that the provision in the Forward Sale Confirmation that delivery could be effected "without the need for any confirmation from the owner/operator of the Storage Facility" meant that it could be deemed to have made delivery even where there was no actual delivery under the Act. Further, it said that this was the case even if the metal no longer existed. The judge agreed that this was the effect of the relevant wording, but held that it was inconsistent with words earlier in the same sentence which appeared to require actual delivery to take place within the terms of the Act. He also held that the relevant words were inconsistent with the Master Agreements and the commercial scheme of the transaction. On that basis, the judge struck down the relevant wording.

He was then required to consider whether, instead of delivering the metal, Citi could assign its right to the metal, or to the benefit of insurance policies. A clause in the Master Agreements permitted it to do so where, *inter alia*, Citi wished but was unable to deliver the metal, and this was not the result of a Termination Event. The judge held that Citi could not take advantage of this provision. First, it had not asked the warehouse operators to attorn to Mercuria, so was not in a position to say that it was unable to deliver the metal. Second, even if it was unable, this was the result of a Termination Event.

The judge was not, however, willing to order that Citi pay damages to Mercuria for its failure to deliver the metal. He held that the suspension of Mercuria's payment obligations pending delivery did not impose on Citi an obligation to deliver, or to deliver by a particular date.

In relation to the validity of Citi's BFE Notices, the questions the judge was required to decide were whether Citi held the opinion stated in the BFE Notices (as to the satisfactory nature, or otherwise, of the storage facilities) and whether its view was reasonable. The judge decided in favour of Citi on both issues. In doing so, he held that the requirement that Citi's opinion be reasonable meant reasonable in the *Wednesbury* sense of not being an opinion which no reasonable person in Citi's position could hold.

The judge also held that, as the BFE Notices were valid, Mercuria had been obliged to pay for the metal. Its future payment obligations were suspended by the service of its notices of a Termination Event, but such notices did not affect payment obligations which had already accrued.

Regulatory developments

For further information or analysis in relation to any of the issues raised below, please contact us direct.

Senior Managers regime

The FCA and the PRA have published further material in relation to the implementation of the new provisions relating to individual accountability in banking, including the Senior Managers regime, the certification regime, and the conduct rules. The initial consultation paper was published by both regulators in July 2014, with a further consultation in relation to forms and transitional provisions in December 2014.

In the first half of this year, the FCA and the PRA have published:

Approach to non-executive directors in banking and Solvency II firms and Application of the presumption of responsibility to Senior Managers in banking firms.

FCA CP 15/5 and PRA CP7/15, February 2015

In this Consultation paper, the FCA and the PRA set out their revised approach to the application of the Senior Managers regime to non-executive directors. The PRA also consulted in relation to its approach to the presumption of responsibility.

Feedback on FCA CP14/13 and PRA CP14/14 and consultation on additional guidance

FCA CP 15/9, March 2015

In this Consultation Paper, the FCA provided its comments on the feedback it had received to its original consultation of July 2014. It provided "near-final" text of some of the new Handbook content it will introduce, much of which was substantially reworked as compared with the version attached to the July 2014 CP. The FCA also provided draft guidance in relation to its approach to the presumption of responsibility.

UK branches of foreign banks

FCA CP 15/10, March 2015

In this Consultation Paper, the FCA set out its proposals for how the new regime for individual accountability would apply to the UK branches of foreign banks, including those based inside the EEA.

Strengthening accountability in banking and insurance: Responses to CP14/14 and CP26/14

PRA PS 3/15, March 2015

This Policy Statement contains the PRA's final rules in relation to much of the Senior Managers regime and certification regime. Importantly, the Policy Statement does not include some remaining aspects on which it needs to co-ordinate with the FCA, as well as issues in relation to which it is still considering the responses to its consultation. The latter category includes: transitional provisions and forms; non-executive directors; the presumption of responsibility; and application of the new regime to UK branches of foreign banks.

Corporate governance: Board responsibilities

PRA CP 18/15, May 2015

While not strictly part of the Senior Managers regime, this consultation by the PRA is expressly stated to complement it. In the consultation paper, the PRA seeks views on a draft supervisory statement setting out its expectations in relation to a wide range of issues, including the respective roles of executive and non-executive directors. This is a distinction which has been under some scrutiny in relation to the application of the Senior Managers regime to non-executive directors (it will now apply to a much smaller number than originally proposed). The short draft supervisory statement makes it clear that the PRA expects firms to provide non-executive directors with adequate training and practical resources, and that they must have unrestricted access to employees and information, in order to discharge their duties. The quality of management information has recently been a recurring theme from regulators, and the PRA sets out its expectation that boards insist on receiving neither too little nor too much management information.

Finalised Guidance 15/1

Retail investment advice: Clarifying the boundaries and exploring the barriers to market development

FCA FG 15/1, January 2015

The FCA published FG15/1 in order to consolidate existing sources of

guidance on retail investment advice, and to clarify what does and does not amount to advice or a personal recommendation (which must comply with COBS 9) in that context. While the Guidance is helpful in many respects, particularly in terms of consolidating existing guidance, it leaves some difficult questions unanswered. It also serves, at times, to highlight some potentially significant differences in approach between the FCA and the common law approach to sales of financial products to retail customers.

Holmcroft Properties Limited

Holmcroft Properties Limited was held to have a sufficiently arguable case to be granted permission to bring judicial review proceedings against KPMG. KPMG is the skilled person appointed by Barclays pursuant to section 166 of FSMA in relation to its review of sales of interest rate hedging products. A transcript of the court's judgment at the permission stage does not appear to have been produced, but reports from those acting in the proceedings indicate that Holmcroft alleges that the process followed by KPMG was unfair and/or unlawful. Holmcroft's application for permission was apparently opposed by KPMG, Barclays and the FCA, and one very interesting aspect of its challenge will be whether it succeeds in persuading a court that a skilled person appointed in this way is amenable to judicial review.

Fall-out from the London Whale

R (on the application of Julien Grout) v. Financial Conduct Authority [2015] EWHC 596 (Admin)

One of the traders involved in the London Whale trades, Julien Grout, who has been indicted in the US in relation to his role, applied for judicial review of the FCA's decision to terminate its investigation into his conduct. The challenge (which unsurprisingly failed) was apparently made in order that Mr Grout might have an opportunity to clear his name.

The Financial Conduct Authority v. Macris [2015] EWCA Civ 490

The Court of Appeal also considered an appeal by the FCA from a decision of the Upper Tribunal on a preliminary issue in a reference of certain FCA notices made by Mr Grout's ultimate boss, Achilles Macris. Mr Macris alleged that the FCA's warning, decision and final notices to JP Morgan in relation to the London Whale trades (the Notices) identified him, and that under section 393 of FSMA, he should therefore have been provided with copies of them in advance of their promulgation. Both the Upper Tribunal and the Court of Appeal agreed that Mr Macris was identified in the Notice. The question of whether an individual person (other than the recipient of the notice) was identifiable from a notice was to be answered by reference to the notice alone. However, once it was clear that an individual was identifiable, documents and information external to the notice could be considered in determining whether those acquainted with the

individual or operating in his or her professional sector would recognise him or her from the references in the notice. The decision has a number of interesting possible implications, including for the way in which the FCA drafts notices, and for its future conduct of investigations.

Final notices

Confllicts of Interest

Aviva Investors, 24 February 2015

Aviva Investors is an asset management company. It was fined £17,607,000 by the FCA, in relation to breaches of Principle 3 ("a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"); Principle 8 ("a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client"); and COBS 11.3.2 and COBS 11.5.2 (in relation to execution of client orders and record keeping). Aviva Investors had, over a period of years, allowed its traders to favour one class of clients over another. Its systems and controls did not require traders to allocate investments as soon as they were purchased, allowing them to cherry-pick investments in order to favour funds paying higher performance fees.

Dealing with regulators

Bank of Beirut, Anthony Wills and **Michael Allin**, 4 March 2015

The FCA fined Bank of Beirut £2.1 million and restricted it, for a period of 126 days, from acquiring customers resident or incorporated in high-risk jurisdictions. The FCA's initial concern in relation to Bank of Beirut related to its implementation of AML and financial crime safeguards, but it was eventually penalised for breach of Principle 11 ("A firm must deal with its regulators in an open and co-operative way, and must disclose to the [FCA] appropriately anything relating to the firm of which the [FCA] would reasonably expect notice"). The FCA found that Bank of Beirut had not been open and cooperative with it in relation to the implementation of agreed remediation plans.

Responsibilities of Compliance officers

Stephen Bell, 14 March 2015

Mr Bell was Compliance Director for Financial Limited and Investment Limited, two affiliated firms which formed an adviser network, responsible for a number of Appointed Representatives (ARs) and Registered Individuals (RIs). He was fined £33,800 and prohibited from performing CF10 (Compliance Oversight function), as a result of being found to be knowingly concerned in the two firms' breach of Principle 3 (which requires a firm to organise and control its affairs responsibly and effectively, with adequate risk management systems). The firms' breaches related to their recruitment and supervision of RIs and ARs.

Responsibilities of Compliance officers

Peter Legerton and **Lloyd Pope**, 20 March 2015

Both Mr Legerton and Mr Pope were directors of TailorMade Independent Limited (TMI) (in liquidation). TMI advised clients seeking to transfer their pension funds to unregulated investments using a SIPP. As well as being directors, Mr Legerton and Mr Pope both (at separate times) had responsibility for the compliance oversight function. TMI did not, contrary to the FCA's requirements, provide its clients with any advice as to the suitability of the investments underlying the SIPPs they proposed to enter into, only the suitability of the SIPP wrapper. TMI also failed to manage conflicts of interest appropriately. Mr Legerton and Mr Pope were found to have breached Approved Person Statement of Principle 7 (requiring an approved person performing a significant influence function to take reasonable steps to ensure that the business of the firm for which he or she is responsible in that controlled function complies with the requirements of the regulatory system).

Complaint handling

Clydesdale Bank plc, 14 April 2015

The FCA fined Clydesdale £20,678,300 for failings in its handling of PPI complaints which amounted to a breach of Principle 6 (which requires a firm to pay due regard to the interests of its customers and treat them fairly). In particular, the FCA found that Clydesdale's complaint-handlers did not look for documents which might exist, because it was difficult to do so, or because the documents predated the bank's seven-year document retention policy. Some complaint-handlers (without Clydesdale's knowledge) also falsified documentary evidence in response to requests for information from the Financial Ombudsman Service. In addition to paying a fine, Clydesdale agreed that it would review all PPI complaints handled before August 2014, under the oversight of a skilled person.

CASS breaches

The Bank of New York Mellon London Branch (BNYMLB) and The Bank of New York Mellon International Limited (BNYMIL), 14 April 2015

BNYMLB and BNYMIL were fined £126 million in relation to numerous breaches of the FCA's CASS rules and Principle 10, which says that a firm "must arrange adequate protection for clients' assets when it is responsible for them". At the heart of many of the failures identified by the FCA was the fact that both entities used group custody platforms which operated at a global, rather than an entity-specific, level. While records identified the name of the client and the assets, they did not record which BNY Mellon entity was party to the relevant custody agreement.

Transaction reporting failures

Merrill Lynch International (MLI), 22 April 2015

The FCA fined MLI £13,285,900 in relation to failures in transaction reporting in breach of SUP 17.1.4R and SUP 17.4.1 EU over a seven-year period. It identified 11 different breaches of reporting requirements. The Final Notice reiterates the importance of transaction reporting, in order to allow the FCA to perform market surveillance, and to inform investigations into insider trading and market manipulation. The FCA increased the relevant metric for the purposes of calculating penalties under DEPP in relation to transaction reporting from £1 to £1.50 per breach, in order to provide greater deterrent.

Benchmark manipulation

Deutsche Bank, 23 April 2015

Deutsche Bank was fined £226 million in relation to benchmark manipulation, in breach of Principles 3 (requiring firms to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems), 5 (requiring firms to observe proper standards of market conduct) and 11 (requiring firms to deal with their regulators in an open and co-operative way). The FCA found that the direct involvement of managers and senior managers in the breaches identified aggravated the breaches.

In relation to Principle 5, the FCA found that Deutsche Bank traders had asked the firm's own submitters, and those from other firms, to influence IBOR submissions, and had occasionally offered or bid cash in the market in order to influence the submissions of other banks. The rates traders were found to have attempted to manipulate most frequently were JPY, CHF and USD LIBOR and EURIBOR, and less frequently GBP LIBOR. The FCA notes, however, that traders on FX Forward desks also made requests to influence other benchmarks.

In relation to Principle 3, the FCA found that Deutsche Bank did not have IBOR-specific systems and controls in place, and that its systems and controls for detecting trader misconduct were seriously defective, and had hampered the FCA's investigations.

In relation to Principle 11, the FCA identified that Deutsche Bank had recklessly (and incorrectly) told it that Deutsche Bank was prohibited by the German regulator, BaFin, from providing it with a report; that an individual at Deutsche Bank had drafted an attestation to the FCA confirming the adequacy of IBOR-related systems and controls, while knowing such attestation to be false; and that Deutsche Bank had failed to provide complete, accurate and timely information and documentary evidence.

The final notice refers repeatedly to shortcomings in the culture at Deutsche Bank, and highlights the importance of firms being practically able, as well as willing, to assist FCA investigations.

Benchmark manipulation

Barclays Bank, 20 May 2015

Barclays, which went first in relation to LIBOR settlements with the FCA, appears to have gone last in relation to FX manipulation and has received the largest fine ever imposed by the regulator. It has been fined £284,432,000 for failings occurring between 1 January 2008 and 15 October 2013. Unlike some other final notices, this one identifies not only manipulation of G10 spot rates, but also Emerging Markets spot FX trading, G10 and EM FX options, and sales operations associated with its FX business. Like other banks fined for manipulation of FX rates, Barclays was found to have been in breach of Principle 3, which requires firms to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems. Too much reliance was placed on front office as the first line of defence, and such reliance was misplaced. As a result, Barclays was found to have colluded with other banks in order to manipulate spot rates for its own benefit; to have colluded in order to trigger stop-loss orders; and to have shared confidential information inappropriately.

Keydata

Stewart Ford, Mark Owen and **Peter Johnson,** 26 May 2015 (decision notices dated 7 November 2014)

The FCA proposes fining Stewart Ford, Mark Owen and Peter Johnson (£75 million, £4 million and £200,000 respectively) and banning them from performing any function in relation to any regulated activity carried on by an authorised person, exempt person or exempt professional firm, in relation to events surrounding the collapse of Keydata. The FCA's decision notices are dated 7 November 2014, but were only published on 26 May 2015.

The penalties proposed by the FCA are for breach of the Statements of Principle for Approved Persons 1 (which requires an approved person to act with integrity in carrying out his or her controlled function) and 4 (which requires an approved person to deal with regulators in an open and co-operative way and disclose appropriately any information of which the regulators would reasonably expect notice).

The decision notices set out the FCA's detailed reasoning (as well as a summary of the representations made by the individuals, and the FCA's response to them). At the heart of the failings identified is Keydata's continued sale of high-risk products, despite knowing that its product disclosures were inadequate; that not all the products offered would meet the requirements of the ISA Regulations; and that there were problems with the performance of the investments. The FCA also identified high, and in its view unearned, fees paid to entities beneficially owned by Mr Ford's family in connection with investments made by clients of Keydata, amounting to some £72.4 million, as well as undisclosed commissions of £2.5 million paid by Mr Ford to Mr Owen. In addition, the FCA found that all three individuals had failed to disclose information to it, or correct information they knew would be misleading.

All three individuals have referred the decision notices to the Upper Tribunal.

Other developments

FCA's priorities for 2015-2016

FCA Business Plan, March 2015

The FCA produced its Business Plan for 2015-2016, including its Risk Outlook, and an appendix containing details of current and planned thematic work and market studies. In its Risk Outlook, the FCA retained some of its areas of forward-looking focus from last year, as well as adding new areas of particular scrutiny. Its list included the risks posed by poor culture to market integrity, including conflicts of interest. The Risk Outlook also discussed business conduct risk, risks posed by the identity and behaviour of consumers, conflicts of interest and the risks posed by financial crime.

We consider in our introduction to this edition of Financial Markets Disputes and Regulatory Update what can be gleaned from the Business Plan in relation to areas to watch over the next six months.

"Risks to customers from performance management at firms" and "General guidance on the application of ex-post risk adjustment to variable remuneration"

GC 15/1 and **GC 15/2,** March 2015

In GC 15/1, the FCA consulted on guidance in relation to how firms' performance management (both formal and informal) of their customer-facing staff could cause detriment to customers if firms rewarded or promoted the wrong types of behaviour. While the FCA said that its work (particularly with whistleblowers) had detected some issues, it had not identified a widespread problem. The paper contains detailed discussion of practices which could have a negative effect, such as excessive focus on sales targets and publishing each employee's sales figures, as well as giving examples of good practice.

In GC 15/2, the FCA consulted on guidance to replace that previously appended to its joint consultation (CP 14/14) with the PRA in relation to remuneration, following the recommendations of the Parliamentary Commission on Banking Standards. Specifically, the guidance deals with ex-post risk adjustment to take account of specific crystallised risks or adverse performance outcomes.

Insider dealing

The FCA has also been active in relation to insider dealing. In March 2015, Julian Rifat (formerly of Moore Capital) was sentenced to 19 months' imprisonment. The FCA secured two convictions for insider dealing in the first months of 2015, and 10 other individuals charged with insider dealing await trial.

Publication of terms of reference for investment and corporate banking market study

FCA MS 15/1.1, May 2015

The FCA has produced the terms of reference for its forthcoming study into whether competition for investment banking and corporate banking services is working well. The FCA will look primarily at Equity Capital Markets, Debt Capital Markets, mergers and acquisitions and acquisition financing. It will look at so-called "related activities" such as corporate lending and corporate finance and advice only to the extent that they touch on these primary activities. The FCA has identified three principal topics for consideration: choice of banks and advisers; limited transparency; and bundling and cross-subsidisation of investment and corporate banking services. It will not consider, as part of this study, two issues previously raised, which are: best execution of client orders; and barriers to entry in corporate banking.

The FCA's final report is not due to be published until spring 2016, but it has said that it intends to produce an interim report.

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