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Insight

Dentons Financial Markets and Regulatory Update

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In this edition of *Dentons Financial Markets and Regulatory Update,* we have considered the key financial markets cases, and UK conduct-related regulatory action, from the second half of 2016, and summarised 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.

Contents

What is worth remembering from the second half of 2016?

Court decisions/impacts

In the first half of 2016, there were a number of interesting judgments in relation to agreements concluded on standard terms which are likely to be of relevance to those using such documents in future. This theme continued throughout the second half of the year, with the Court of Appeal decision in *Cheyne Capital v. Deutsche Trustee Company*, which concerned general principles of contractual interpretation in the context of a CMBS transaction, and the High Court decision in *Lehman Brothers International (Europe) v. ExxonMobil Financial Services BV*, in which the court considered the termination provisions contained in the Global Master Repurchase Agreement 2000 and the meaning of the phrase "close of business" in that context.

Further, there have been a number of cases dealing with procedural issues, including the first judgment in a case conducted under the new Shorter Trials Scheme pilot. Meanwhile, on the issue of costs, the Court of Appeal has also upheld a first instance decision regarding the liability of third party litigation funders for costs on an indemnity basis.

Regulatory developments

The second half of 2016 saw substantial further developments in relation to the application of the SMR.

In the first half of the year, the FCA promised to clarify its position as regards overall responsibility for the legal function within banks, and whether that person required approval under the SMR for a senior management function. In September 2016 the FCA published a Decision Paper on that issue, which sets out what the FCA considers to be the risks and benefits of potentially including the head of legal within the SMR. The issue has provoked considerable controversy and, perhaps understandably, the prevailing view of the majority of those within the legal profession, including the Law Society and the BBA, is that the legal function should not fall within the scope of the SMR. Particularly for those working within the legal function of banks and other financial institutions, this issue is likely to have been the most significant regulatory development of the second half of 2016.

In addition, the regulators have published a consultation paper regarding their proposed amendments to DEPP, explaining how the duty of responsibility under the SMR, which replaced the controversial presumption of responsibility for SMFs, will be enforced. The consultations set out the considerations which the FCA and PRA will take into account when determining whether a particular SMF was responsible for the activities which the breach concerned.

What to watch out for

Litigation

The judgment in *Property Alliance Group Ltd v The Royal Bank of Scotland plc (RBS) [2016]* EWHC 3342 (Ch), which was handed down on 21 December 2016, is likely to have considerable significance for financial institutions throughout 2017. This was the first LIBOR case to be taken to trial, and the Court dismissed all of PAG's claims. For queries relating to this case, please contact any of the Dentons team members set out on page 27 of this Update.

The first half of 2017 is likely to see the handing down of judgment in a number of significant cases, including:

- the appeal by Portuguese transport company, Companhia de Carris de Ferro de Lisboa SA, and others against Banco Santander (please see our summary of the first instance decision here)

- the trial of the Libyan Investment Authority's claim against Sociéte Générale, which is due to begin in April 2017. We summarise below the decision in the "Libyan Investment Authority's claim against Goldman Sachs".

Regulatory and other developments

A number of significant publications from the second half of this year are likely to have further implications into 2017, particularly in the context of the SMR.

9 January 2017 is the relevant date by which firms must respond to various of the regulators' publications regarding the SMR, including the FCA's consultation on the application of the Conduct Rules to NEDs and the proposed amendments to DEPP regarding the enforcement of the duty of responsibility, in relation to which final rules are expected later in 2017. Responses to the FCA's discussion paper regarding overall responsibility for the legal function are also due by 9 January 2017. The FCA has stated that it will issue a consultation in due course, and provide information on any transitional measures which may be needed for firms, once it has reviewed the feedback to its discussion paper.

Apart from the SMR, following its consultation in August 2016, the FCA is also expected to make a further announcement in Q1 2017 regarding its proposed rules in relation to PPI complaints, in particular its proposal that a cut-off be introduced by which any future complaints must be received.

Judgments

Third party litigation funding – Court of Appeal decision on costs liability

Excalibur Ventures LLC v. Texas Keystone Inc and others [2016] EWCA Civ 1144

November 2016 saw the Court of Appeal unanimously dismiss an appeal brought by various third party litigation funders regarding their liability for the defendant's costs in connection with the *Excalibur* case.

In the first instance decision of the High Court, it was determined that the third party funders in the *Excalibur* case would face joint and several liability for the defendant's costs on the same basis as the funded party itself, including where that party had been ordered to pay costs on an indemnity basis.

The third party funders sought to appeal the decision that they should pay costs on an indemnity, rather than a standard, basis. However, the court rejected the argument that it was inappropriate for the funders to pay costs on the indemnity basis where their own conduct, as opposed to the conduct of the claimant, had not been criticised. In that respect, the court referred to the fact that a claimant himself may face liability for indemnity costs not only on account of his own behaviour but on account of the conduct of others, including lawyers, experts or witnesses, even if he is not personally responsible for that conduct. The court stated that it was the derivative nature of a commercial funders' involvement that should ordinarily lead to the funder being required to contribute to costs on the same basis as those whom he elected to fund. That is not to say that there is an irrebuttable presumption that this would be the outcome; rather, the court considered that this outcome would ordinarily be just and equitable.

Further, the court concluded that there was no reason to limit an order for non-party costs to only those funders who had entered into a contractual relationship with the claimant. Rather, the court determined that it would be just and appropriate to make an order for costs against a person who provided funding and who, in reality, will obtain the benefit of the litigation if the funded party is successful. Clearly, if this were not the case, then any risk of adverse costs orders could be circumvented through the use of an SPV.

This decision will mean, therefore, that an order for costs may be made against the parent company of the commercial litigation funder. The court rejected the argument of the funders that this approach served to pierce the corporate veil, on the basis that the exercise of the discretion to make a non-party costs order does not amount to an enforcement of legal rights and obligations, to which the doctrine of corporate personality is relevant. The relevant issue was whether, in the circumstances, it was just to make an order for a non-party to pay costs in light of the nature of its involvement in the case; this will not pierce the corporate veil, but simply gives effect to the proposition that it is just and appropriate to make an order for costs against a person who has provided funding and would, in reality, have obtained the benefit of the litigation if successful.

In addition, the court allowed that funds provided for security for costs should be taken into account in calculating the Arkin cap. That is, the principle which limits a funder's liability on costs to the amount of funding which it has already provided.

Interestingly, Tomlinson LJ, in giving the leading judgment, addressed the concern that, to avoid being fixed with the conduct of the funded party, the funder would have to exercise greater control over the conduct of the litigation throughout and that this would give rise to a risk that the funding agreement itself was champertous.

Tomlinson LJ considered that such a concern was "unrealistic". Champerty involves behaviour which is likely to interfere with the due administration of justice; litigation funding, on the other hand, is an accepted activity, perceived to be in the public interest. Tomlinson LJ considered that a rigorous analysis of the law, facts and witnesses in a case, consideration of proportionality and review at appropriate intervals is what is to be expected of a responsible funder and cannot, therefore, be champertous since such activities promote, rather than interfere with, the due

administration of justice. Tomlinson LJ emphasised that, when conducted responsibly, there was no danger of such involvement or regular reviews of the case being characterised as champertous.

This decision is of considerable significance for commercial funders, and marks an important acknowledgment by the Court of Appeal that such funding arrangements are not themselves champertous. As such, commercial funders are likely to take comfort from the clarification provided by Tomlinson LJ that the funder need not avoid an active role in reviewing and monitoring the case for fear of champerty.

This is one of a number of cases recently before the courts concerning the role of third party funders. For example, in *Wall v. The Royal Bank of Scotland plc* [2016] EWHC 2460 (Comm), the High Court ordered that the claimant disclose the identity of the third party funder. The appeal of that decision is to be heard in March 2017 by the Court of Appeal.

Rights of Class G noteholders in CMBS transaction

Cheyne Capital (Management) UK (LLP) v. Deutsche Trustee Company Limited and another [2016] EWCA Civ 743

In our previous edition of this Update, we discussed the judgment of Arnold J in the first instance decision regarding this CMBS transaction. The Court of Appeal has since published its judgment upholding that first instance decision.

In this case, subordinated Class G notes were agreed to be the Controlling Class for the purposes of the transaction. This entitled that class of noteholders, represented by Cheyne as Operating Adviser, to exercise certain rights, including the power to replace the Special Servicer. Cheyne notified the trustee of the issue that it wished to replace the Special Servicer appointed in relation to defaults that had occurred in the underlying loan.

However, under clause 26.4(b) of the Issuer Servicing Agreement, replacement of the Special Servicer could take place only where the relevant ratings agencies had confirmed that the appointment of the successor special servicer "*will not result in an Adverse Rating Event, unless each class of Noteholders have approved the successor Issuer Servicer or successor Issuer Special Servicer, as applicable, by Extraordinary Resolution.*"

The applicable ratings agencies in this case were Moody's, Fitch and S&P. This meant that, in effect, before the replacement of the Special Servicer could take place all three ratings agencies would have to confirm that the replacement would not result in a downgrade of the notes. If each of the ratings agencies would not provide that confirmation, the replacement could only take place if approved by an extraordinary resolution of each class of noteholders. Problems arose because, from December 2012, as a matter of public policy Fitch would not provide such confirmations in the context of CMBS transactions.

In the proceedings, Cheyne contended that the relevant clause of the Issuer Servicing Agreement, as set out above, should be interpreted to mean that confirmations were required from the rating agencies that were willing in principle to provide them. However, the trustee argued that this was not what the agreement said; the relevant clause required confirmation from all three ratings agencies or, as an alternative solution if it was not possible to obtain such confirmation, an extraordinary resolution of noteholders.

The Court of Appeal upheld the first instance decision, and concluded that the natural and ordinary meaning of the relevant clause was that confirmation was required from all three rating agencies. This could not be disregarded because one ratings agency ceased to provide such confirmations as a matter of policy. Further, the natural and ordinary meaning of the words in that clause did not produce a commercially absurd result, since the wording provided the alternative of obtaining an extraordinary resolution.

Importantly, the CMBS transaction in this case followed a broadly standard structure, and Fitch's policy is of general application. Accordingly, the judgment is likely to be of considerable significance for other CMBS transactions. This is unlikely to be the only CMBS transaction in which the contractual drafting, as here, does not achieve the result which the Controlling Class might wish.

Interestingly, the court considered the decision in *US Bank Trustees Limited v. Titan Europe 2007-1 (NHP) Ltd [2014]* EWHC 1189 (Ch), which also concerned the failure of a ratings agency to provide confirmation on the replacement of a special service provider. In that case the court concluded that the relevant clause did not require confirmation from all of the ratings agencies in question. However, crucially, the relevant clause in *Titan* did not contain the option for an extraordinary resolution. The court considered, therefore, that it would make no commercial sense for the replacement of the special servicer to be prevented by a general policy implemented by Fitch. Accordingly, there were material differences between the two documents in the two cases.

English court has no jurisdiction over US$800 million claim

Goldman Sachs International v. Novo Banco SA 2016 WL 06476222

In November, the Court of Appeal overruled a 2015 High Court decision and determined that a £835 million debt claim brought by Goldman Sachs and others against Novo Banco must be pursued in Portugal.

In August 2014, the financial difficulties of Banco Espirito Santo (BES) prompted the central bank of Portugal, Banco de Portugal, to establish a new financial institution, Novo Banco. Pursuant to the domestic legislation which incorporated the EU Reorganisation and Winding Up Directive (EC/2001/24) and the Recovery and Resolution Directive (2014/59/EU) most, but not all, of the assets and liabilities of BES were transferred by Banco de Portugal to Novo Banco.

However, questions arose as to whether the liabilities of BES under a facility agreement with investment fund, Oak Financing, had been transferred to Novo Banco. In December 2014, Banco de Portugal declared that the obligations of BES under the relevant facility agreement had not been so transferred.

The respondents, as assignees of Oak Financing, sought to recover interest and capital payments under the facility agreement and commenced proceedings in England against Novo Banco. They sought to argue that the liability owed to Oak Financing had been transferred to Novo Banco and that the decisions of the Bank of Portugal in December 2014 had no effect on that transfer. As such, Novo Banco was a party to the facility agreement, and was therefore bound by the English jurisdiction clause contained therein.

We summarised the first instance decision in a previous edition of this Update. In essence, the High Court held that the claimants had the better of the argument that the Oak Financing liability had been transferred to Novo Banco, and was therefore bound by the English jurisdiction clause.

That decision was overturned on appeal, with the Court of Appeal concluding that the actions taken by Banco de Portugal under the relevant EU directive did not trigger the jurisdiction clause under the facility agreement.

The Court of Appeal stated that the fundamental principle underlying the reorganisation and winding-up of financial institutions within the EU is that it is for the home Member State to determine how to deal with a failing institution; its decisions should be accorded universal recognition. If that is to be achieved, it is essential that other Member States give reorganisation and resolution measures the same effect that they have under the domestic law of the relevant home state. If it were open to the English courts to hold that the effect of the decision to transfer certain liabilities to Novo Banco is other than the effect which the decision has under Portuguese law, this would violate the principle of universal recognition on which the law in this area is based.

Interestingly, one member of the court, Sales LJ, indicated that, if necessary, he would have held that the December 2014 decision by Banco de Portugal should be recognised as a re-transfer of the Oak Financing liabilities from Novo Banco back to BES. Gloster LJ disagreed, taking the view that the December decision should not be characterised as "rewriting history" in the manner proposed by Sales

LJ. In any event, those points were not material since the court was in agreement on the appropriate disposition of the appeal.

The judgment is significant in reinforcing the importance of the universal application of the exceptional measures taken by Member States to ensure an orderly and consistent approach to the failure of credit institutions in the wake of the financial crisis. In that respect, the judgment is perhaps unsurprising. However, the decision may give rise to concerns for financial institutions in that it creates a measure of uncertainty around the application of jurisdiction clauses which will inevitably have formed part of innumerable standard form facility agreements.

This case also forms part of an emerging trend of financial markets cases concerning the application of jurisdiction clauses; the Court of Appeal considered similar issues in the Banco Santander case, which was also heard in November and in respect of which judgment is awaited.

The respondents are seeking permission to appeal to the Supreme Court.

First judgment in Shorter Trials Scheme

National Bank of Abu Dhabi v. BP Oil International Ltd [2016] EWHC 2892 (Comm)

In November, judgment was handed down in the first case conducted under the new Shorter Trials Scheme pilot.

The case concerned a claim brought by the National Bank of Abu Dhabi (the Bank) against BP for breach of warranty and representation contained in a purchase letter for a receivable debt which was owed to BP, and which the Bank purchased before the debtor fell into insolvency. The Bank was awarded damages of nearly US$70 million.

Whilst the facts of the case are not particularly noteworthy, the judgment does provide invaluable insight into the approach taken within, and the potential benefits of, the Shorter Trials Scheme.

In its judgment, the High Court praised the co-operative spirit with which the litigation had been conducted, which had resulted in such a speedy and effective process – as envisaged by the Scheme. The claim itself was issued in March 2016 and the trial took place on 7 November, with judgment handed down just two weeks later. There was only very limited disclosure in the case, no witness statements and no oral evidence at all. As a result, the case proceeded with considerable efficiency, in respect of costs as well as time; total costs for both sides amounted to approximately £350,000.

The benefits of such an approach are obvious. However, this approach is unlikely to be practicable for many financial markets cases given the complexity of the factual and legal issues which such litigation tends to involve. Here, the facts of the case were relatively straightforward, and the issue which it fell to the court to determine was one of contractual interpretation, and what should be the natural and ordinary meaning of certain clauses within the purchase letter. Further, despite the high value of the case, there was no dispute as to quantum.

It remains to be seen how the courts will approach other cases within the pilot, and whether the efficiencies and speed seen in this case are the exception, or can be achieved in a broad range of cases.

Meaning of "close of business" in repo transactions

Lehman Brothers International (Europe) v. Exxonmobil Financial Services BV [2016] EWHC 2699 (Comm)

In this Lehman Brothers International (Europe) (LBIE) case, the High Court has considered the construction of the termination provisions contained within the Global Master Repurchase Agreement 2000 (GMRA) following an event of default in a repo transaction.

When LBIE went into administration on 15 September 2008, there was an outstanding repo transaction between the parties under which LBIE sold ExxonMobil Financial Services (ExxonMobil) a portfolio of equities and bonds for US$250 million, and agreed to repurchase them the following day.

The primary issues in dispute concerned (i) when the Default Notice had been served, LBIE saying this took place on 15 September 2008 and ExxonMobil claiming it took place on 16 September 2008, and (ii) whether, in light of that timing, ExxonMobil had validly exercised the Default Valuation Notice procedure in the GMRA.

There were over 20 issues before the court for decision, the most significant of which are summarised below.

First, ExxonMobil claimed that its initial Default Notice, sent by fax on 15 September 2008, was invalid, as it did not specify what event of default had occurred. As a result, ExxonMobil argued that only its second fax, delivered on 16 September 2008, constituted a valid Default Notice – starting the clock running on timing for service of its Default Valuation Notice.

The court disagreed, and determined that it was not necessary for a default notice to state that an event of default had occurred, or to identify the specific event of default, in order for the notice to be valid.

Interestingly, paragraph 14(b) of the GMRA 2000 states that notices are effective if sent by "electronic messaging system". The court stated, albeit obiter, that it considered this would include email.

As regards the Default Valuation Notice, LBIE claimed that this was invalid, on the basis that the fax

number to which it was sent was not the number specified in the GMRA. The court considered that, in general, pursuant to paragraph 14 of the GMRA, faxed notices should be sent to the number contained within Annex 1 of the agreement.

However, it is possible for that requirement to be waived. In this case, LBIE had in fact received the faxed notice, which was sent to a different fax machine within the same office because the contractually specified fax machine was busy. The Default Valuation Notice was logged by LBIE in the usual way, and no point was taken that it was invalid, on the basis of having been sent to the wrong fax machine, either at the time or at any point during the following six years, including in LBIE's original Particulars of Claim. As such, the court determined that LBIE had waived the requirement for service at the fax number specified in the agreement, and service of the Default Valuation Notice was valid.

The fax itself was received at 6.02pm on 22 September 2008 in London. Paragraph 14(b) of the GMRA provides that any notice delivered after the close of business on the day of receipt should be treated as given at the opening of business the following day. As such, LBIE claimed that the Default Valuation Notice was served on 23 September 2008, on the basis that the close of business in London is 5pm.

The court disagreed, and concluded that, for international commercial banks engaging in repo transactions, close of business was around 7pm. Accordingly, the notice was received on 22 September 2008.

The court emphasised that the decision in this case as regards the meaning of "close of business" was fact-specific. The meaning of the term is dependent upon the context in which it is used, and implies a degree of flexibility, allowing for commercial good sense, which will differ based on the particular facts of the transaction in question.

The court also considered the basis on which the securities themselves had been valued. In accordance with the GMRA, ExxonMobil, as the non-defaulting party, was to establish the Default Market Value of the relevant securities by reference to the Appropriate Market at the Default Valuation Time. In that respect, the court concluded that, whilst there was a "global market" in securities in the general sense, for the purposes of the GMRA, it was not open to ExxonMobil to determine a single Appropriate Market for all of the securities; this should have been done on a security-by-security basis.

The significance of the judgment for other transactions entered into under the GMRA is clear, and demonstrates the precision with which parties must follow the termination provisions set out in that agreement.

The court's decision is also likely to have broader significance in the context of other finance transactions. In particular, the determination that the phrase "close of business" should be interpreted flexibly, and in accordance with the context of the particular transaction, serves as a reminder that, as the court itself noted, if the parties intend for there to be a definite cut-off time by which notice must be received, the safest approach is for the contract to expressly set out what that cut-off time is.

Court of Appeal overturns High Court decision on misrepresentation

Taberna Europe CDO II Plc v. Selskabet AF 1.September [2016] EWCA Civ 1262

The Court of Appeal has unanimously overturned the 2014 decision of the High Court concerning a claim for misrepresentation brought by Taberna, a purchaser of notes on the secondary market, against the issuer, the failed Danish bank, Roskilde.

The High Court found that, although Taberna had brought the notes from Deutsche Bank rather than Roskilde, section 2(1) of the Misrepresentation Act 1967 nevertheless applied to certain misrepresentations contained in an investor presentation published by Roskilde on its website.

The High Court judgment was somewhat controversial, not least because it appeared to be not entirely consistent with the decision in *Secure Capital SA v. Credit Suisse AG [2015]* EWHC 388 (Comm), which also concerned a claim brought by the purchaser of notes in the secondary market. Further, the courts have long recognised the danger of allowing such third parties to rely on documents which were produced for a purpose other than that to which they have been put, or directed at an audience of which they were not themselves members. Yet the first instance decision in this case gave rise to considerable concern that representations made by firms in publications intended for the primary market could be actionable by secondary market purchasers some time after the publication was issued.

It is of little surprise, then, that the Court of Appeal has allowed Roskilde's appeal. The court stated that section 2(1) is concerned only with the contract which the representee has been induced to enter into directly with the representor, in respect of which a right of rescission would arise, and does not extend to an obligation of a contractual nature which the representee might acquire from a third party, in respect of which there would be no right of rescission. The court noted that the notes, in this case, represented obligations of a contractual nature, but considered that they were better regarded as a species of property which Taberna acquired pursuant to a contract with Deutsche Bank. Any loss suffered by Taberna was, therefore, incurred under that contract with Deutsche Bank, which could have been subject to a claim under section 2(1) of the Misrepresentation Act if any misrepresentation by the bank had induced Taberna to buy the notes – which had not been suggested.

FCA successful in striking out claim for misfeasance in public office

AAI Consulting & ors v. Financial Conduct Authority [2016] EWHC 2812 (Comm)

The FCA has been successful in striking out a claim brought against it for misfeasance in public office and conspiracy, in connection with the investigation by the FSA into Keydata Investment Services Ltd (Keydata) which resulted in its being placed into administration on 8 June 2009. The claimants alleged that the FSA had deliberately and maliciously targeted the firm with the intention of closing it down, in an effort to demonstrate its own effectiveness as a robust regulator in the wake of the financial crisis, and claimed damages in excess of £500 million.

The claim was struck out on 7 November 2016. The judgment itself provides a helpful summary of the elements required in order to establish misfeasance in public office or conspiracy, and is a reminder of the high threshold required to prove either tort.

Undue Influence

The Libyan Investment Authority (incorporated under the laws of the State of Libya) v Goldman Sachs International [2016] EWHC 2530 (Ch)

The Libyan Investment Authority (LIA) has lost a US$1 billion claim brought against Goldman Sachs on the basis that it was subject to undue influence by the bank.

Between September 2007 and April 2008, LIA entered into several transactions with Goldman Sachs, including nine disputed trades which formed the primary focus of this claim. Those trades were leveraged equity derivatives transactions. When the value of the shares to which the trades were linked fell during the financial crisis, the LIA lost its entire premium of US$1.2 billion and sought to rescind the trades on the basis of undue influence and unconscionable bargain.

The LIA sought to assert that, at the time of entering into the relevant trades, it was a naïve and unsophisticated institution and that Goldman Sachs took advantage of that fact. Further, the LIA alleged that Goldman Sachs had sought to improperly influence it to enter into the trades, including by conferring favourable treatment on the younger brother of the LIA's then deputy director, offering him a prized Goldman Sachs internship just a month before the final trade concluded.

The LIA also alleged that the profits which Goldman Sachs made from the trades were so excessive as to give rise to a presumption in the context of a protected relationship that undue influence must have been exercised in order for the LIA to agree to the price offered.

The LIA's claim was rejected in its entirety. The court found that there was no protected relationship of trust and confidence between the parties, and that their relationship did not go beyond the normal cordial and mutually beneficial relationship that arises between a bank and client. As regards the internship, the court rejected the idea that this had a material influence on the decision of the deputy director or the LIA itself. The internship, and the lavish hospitality and expensive entertainment provided by Goldman Sachs, may have contributed to a friendly and productive atmosphere during the negotiation, but nothing more.

The court also found that there were no grounds for concluding that the level of profits earned by Goldman Sachs were excessive. The LIA made much of the fact that Goldman Sachs, even on its own case, made a profit of at least US$130 million on the relevant trades combined. However, the court disagreed that the mark-up charged by Goldman Sachs on the trades was so high as to call for an explanation. Whilst the profits generated by Goldman Sachs may have been "on the high side", this was justified in light of the unusual nature of the trades, the size and risk involved, as well as the work and expense which had gone into winning them, including the cost of travel to Tripoli and the like.

While the subject matter of this case is of considerable interest, the decision was necessarily fact specific. Accordingly, its impact on the wider market is limited.

It is worth noting that the LIA has brought a similar claim against Sociéte Générale, due to be heard in April 2017. However, in that claim the LIA has gone further, and alleges a fraudulent and corrupt scheme on the part of Sociéte Générale.

The LIA is seeking permission from the Court of Appeal to appeal the decision.

Mis-selling of investments

Mr and Mrs O'Hare v. Coutts & Co [2016] EWHC 2224

In September, Mr Justice Kerr dismissed a claim by investors, Mr and Mrs O'Hare, for damages of £3.3 million in relation to five investments made between 2007 and 2010 on the advice of Coutts, which they claimed was negligent. Each investment formed part of a hedge fund or structured derivative. The Court considered the scope of a bank's duty in light of a customer's attitude to risk and the issue of suitability.

Mr and Mrs O'Hare's case in respect of investments made in 2007 and 2008 was that, contrary to their modest investment objectives and risk appetite, Coutts had recommended unsuitable high risk investments with no capital protection. They claimed that Coutts' salesman had neglected to advise them in respect of an increase in risk exposure and applied pressure to invest. Mr and Mrs O'Hare claimed that investments made in 2010 were unsuitable because they involved high counterparty risk.

There was an Agreement to Provide Investment Advice (the Agreement) which conferred an obligation on Coutts "*to work with*" Mr and Mrs O'Hare "*to develop an investment strategy*" and advise from time to time on investments to implement that strategy. The Court found that this meant "*no more than that Coutts would liaise with the O'Hares and recommend products as and when agreed or as and when Coutts considered it appropriate to recommend a particular product*".

In considering the test to be applied to Coutts' advice, the Court took account of the Supreme Court decision in *Montgomery v. Lanarkshire Health Board* [2015] AC 1430, which found that when it comes to explaining risk, the extent of an adviser's duty is not to be governed by the traditional test in *Bolam v. Friern Barnet Hospital* [1957] 1 WLR 582, namely whether the adviser was acting "*in accordance with a practice accepted as proper by a responsible body of men ... skilled in that particular art*". Rather, the applicable duty was "*to take reasonable care to ensure that the [advisee] is aware of any material risks involved ... and of any reasonable alternative*". Although *Montgomery* was decided in a medical context, the Court held that the decision had implications for investment advice.

The Court considered that the parties' expert evidence indicated that there was little consensus about how the treatment of risk appetite should be managed. The regulatory regime was viewed as strong evidence of what the common law requires, since the skill and care to be expected of a financial adviser would ordinarily include compliance with the rules of relevant regulators. The Conduct of Business Sourcebook (COBS) did not include reference to a *"responsible body of opinion with the profession"*, but compliance with the rules would ordinarily be enough to comply with a common law duty to inform.

The Court concluded that COBS added nothing to the obligations found in the Agreement and the common law of negligence. Coutts was required to ascertain the O'Hares' investment requirements and objectives and to advise and inform them in respect of suitable investments. Given the extent of the information provided to Mr and Mrs O'Hare, it was implausible for them to claim that the investments were mis-sold.

The Court found that there was nothing intrinsically wrong with a private banker using persuasive techniques to induce a client to take risks that the client would not otherwise take, provided the client could afford to take those risks and had shown himself willing to take them, and provided the risks were not – avoiding the temptation to use hindsight – so high as to be foolhardy. While it was accepted that Coutts had used persuasive sales tactics, provided the products were suitable there was nothing wrong with using persuasion. Indeed, this was part of the "*raison d'être ... of any bank*". In addition, the Court found that it was not negligent of Coutts to avoid persuading Mr and Mrs O'Hare out of a confident attitude to risk.

Claimants often make much of banks' sales incentives, alleging that they comprise evidence of mis-selling. The Court was not impressed by Mr and Mrs O'Hare's claims in respect of Coutts' "sales culture" and accepted that a bank may employ persuasive sales tactics. The Agreement meant that Coutts had to sell products to Mr and Mrs O'Hare (or earn commission from third party sales) for the relationship to be viable.

The Court's role is to consider whether a bank has exercised the correct balance between ensuring that its client is willing and can afford to take risks and ensuring that the risks are not so high as to be foolhardy. Mr and Mrs O'Hare could afford to take the risks that they took and were provided with detailed information to assist them. The approach in *O'Hare* is significant as it puts much of the burden on the investor. The decision serves as an indicator that the Court will take an increasingly purposive approach to determining whether or not an investment was suitable; responsibility can lie with a "reasonably informed" client. The *Montgomery* test requires a bank to take reasonable care to inform its customer of any material risks, enabling the customer to make its own decision about whether to proceed.

Mr and Mrs O'Hare are seeking permission to appeal.

Regulatory decisions

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

Senior managers regime, certification regime and conduct rules

The introduction of the first stage of the SMR has not slowed the volume of publications from the regulators on this crucial area of reform. Although the regime is now in force, there continue to be developments, most notably regarding the treatment of the legal function. We have set out below the further significant rule changes that have taken place over the last six months, together with related publications.

Overall responsibility for the legal function under the SMR

FCA DP16/4, 28 September 2016

In January the FCA published a Supervisory Statement acknowledging that there was significant uncertainty as to whether the individual with overall responsibility for the legal function within a firm needed approval under the SMR. In this Discussion Paper the FCA:

- explains that its view to-date is that there should be an SMF charged with responsibility for firms' legal function, albeit that individual need not be the head of legal or equivalent;
- acknowledges that its own publications contributed to confusion as to what the correct position was; and
- sets out the arguments regarding whether the legal function should continue to be part of the SMR going forward.

Responses were due by 9 January 2017 with final rules anticipated later in 2017. It remains the case that, until a final position is reached, firms need not depart in the interim from decisions already reached on this point in good faith.

Unsurprisingly the view of many lawyers on this controversial issue is that the legal function should remain outside the SMR. The Law Society and the BBA have already strongly agreed with this primarily on grounds relating to privilege and the difficulties that could arise for in-house counsel if the legal function is part of the SMR. It is clear from the Discussion Paper that there are reasonable arguments on both sides. For further detail and analysis please see our article on this topic.

Policy Statement and final rules on regulatory references

FCA PS16/22, 28 September 2016

As expected the regulators have finalised new rules on regulatory references. These aim to stop the recycling of so-called "rolling bad apples" by imposing more prescriptive reference requirements from firms subject to the SMR and SIMR and requiring all firms to provide references in respect of applicants for SMF, certification and notified NED roles. This is a key part of properly assessing individuals' fitness and propriety.

The most onerous changes apply to banks and insurers. Once the rules come into force they will be required to:

- take "reasonable steps" to seek references from all previous employers covering the past six years. The regulators declined to modify this requirement in respect of overseas or unregulated former employers despite acknowledging that such references may be difficult to obtain and less useful. Instead they have stressed that it is only a requirement to take "reasonable steps" although they do not define what this means;
- provide particular information in response to reference requests, including all breaches of Conduct Rules, in template form. Significantly the final rules now only require disclosure of breaches that resulted in disciplinary action (aligned with the amendments to when Conduct Rules breaches must

be notified to the regulator). Known or suspected breaches are not a mandatory disclosure but may nonetheless have to be included as part of the general requirement to disclose all relevant information. Firms may also amend the template form provided they still comply with the rules;

- update references if new relevant information comes to light. In respect of this the FCA has clarified that it is only intended that firms update the individual's current employer and that this obligation only exists for six years from the date the employee left, save in respect of serious misconduct; and
- have systems in place to keep 6 years of records of disciplinary action and fitness and propriety findings in respect of individuals. Firms will not be in breach of the reference requirements if they omit something they were not required to keep records of.

There are also less significant changes to the reference requirements for all firms primarily to extend the categories of persons they must provide references in respect of to cover certification roles and notified NEDs as well as pre-approved roles. The FCA has given some useful guidance around the overarching requirement applicable to all firms to provide "all relevant information". In particular it states that firms should look to the current guidance on information around upheld complaints etc but that it is not necessary to disclose criminal convictions and only information that has been properly verified should be included. There is a helpful table summary of which requirements apply to which firms on page 26 of the paper.

It is relevant to note that the reference requirements will apply to contingent (i.e. seconded) and contract workers where the role they are carrying out is an SMF or requires certification.

The new rules apply from 7 March 2017, coinciding with the commencement of the full certification regime and application of the Conduct Rules. It seems likely that the more prescriptive requirements may be extended to all firms when the SMR is extended to them in 2018.

FCA Feedback Statements on the implementation of the SMR

FCA FS16/6, FS16/7, FS16/8 and FS16/9, 28 September 2016

These Feedback Statements set out the results of the FCA's supervisory review of the Statements of Responsibility and Management Responsibility Maps submitted by firms prior to 8 February 2016. There is a statement for each type of firm the SMR applies to (i.e. UK banks, credit unions).

In short the FCA is pleased that most firms have engaged with the SMR and "invested a considerable amount of effort" preparing for it. However, they have identified a number of areas where firms may not be meeting the Handbook rules and guidance or may not have fully understood the regime or implemented it correctly. These concern:

- the seniority of individuals designated as SMFs or given particular responsibilities;
- whether all business functions and activities have in fact been allocated to individuals;
- lack of clarity of allocation of responsibilities as between individuals where further detail of the boundary of responsibilities would assist;
- inconsistency between Statements and Maps as to who is responsible for what; and
- insufficient information about governance arrangements, especially for firms which are part of a larger group.

Firms should be reviewing their Statements of Responsibility and Management Responsibility Maps in light of the feedback. Where revisions are needed, consideration will need to be given as to whether these are such as to trigger a requirement to resubmit revised documents.

Proposed amendments to DEPP regarding enforcing the duty of responsibility

FCA CP16/26, PRA CP34/16, 28 September 2016

The 'duty of responsibility' replaced the extremely controversial proposed 'presumption of responsibility' for SMFs and came into force on 10 May. Under the duty of responsibility, the regulators can take enforcement action against SMFs if they are responsible for the management of any activities in their firm in relation to which their firm breaches a regulatory requirement, and they did not take such steps as a person in their position could reasonably be expected to have taken to avoid the breach occurring or continuing.

The consultations set out the regulators' considerations when deciding (i) if a particular SMF was responsible for the activities the breach concerns; and (ii) whether the senior manager took such steps as an individual in their position could reasonably be expected to take.

In respect of (i) it is notable that the regulators will look beyond what is stated in firms' Statements of

Responsibilities and Management Responsibilities Maps and also consider how the firm operated in practice.

In respect of (ii) the test is a mix of objective and subjective with the regulators considering what steps a competent senior manager would have reasonably taken but that notional competent senior manager is attributed with the specific individual's position, role and responsibilities in all the circumstances. This appears to leave scope for an individual's personal situation to be taken into account. In deciding whether the steps taken by the individual were reasonable considerations will include the nature and scale of the firm's business and whether the actions taken were in breach of other legal requirements.

Responses are also due by 9 January 2017 with final rules expected later in 2017.

Consultation on the application of the Conduct Rules to "standard" Non-Executive Directors

FCA CP16/27, PRA CP34/16, 28 September 2016

As a result of strong objections to all NEDs requiring pre-approval as SMF in the final SMR the FCA only designated so-called "approved" NEDs as SMFs where they hold particular roles (e.g. chairmen of particular boards or committees). The FSMA requirement that conduct rules could only be applied to employees meant that the remaining standard NEDs are not currently subject to any of the Conduct Rules in COCON. FSMA has since been amended so that the Conduct Rules may be applied to all directors.

The FCA proposes that standard NEDs be subject to the five FCA individual Conduct Rules and senior conduct rule 4 requiring persons to "disclose appropriately any information of which the FCA or PRA would reasonably expect notice". The intention behind the proposal is that applying COCON to standard NEDs will help raise standards of conduct for these individuals and, by placing additional duties on them, help reduce the risk of future misconduct and mis-selling. As with the other SMR papers, responses were due by 9 January 2017 with final rules expected in the first part of 2017.

Arguably making standard NEDs subject to these Conduct Rules mainly formalises standards of conduct to which NEDs are subject as directors. However, the proposals represent a continuation of the trend towards an increase in potential scope for the regulators to take enforcement action against individuals in the event of future misconduct or breaches by firms.

Final notices

FCA fines, publicly censures and orders Jersey resident to pay restitution for insider dealing and improper disclosure

Gavin Breeze, 15 July 2016

A Final Notice has been published by the FCA in respect of Gavin Breeze, in connection with market abuse in the form of insider dealing. In September 2014, Mr Breeze had been contacted by the CEO of MoPowered plc, in which Mr Breeze was a shareholder. He was informed that the company was seeking to raise new capital via a share placement, at a substantial discount to the company's share price at the time. The FCA concluded that it was clear the information regarding the discounted placement would, once announced, have a substantial impact on the company's share price. However, Mr Breeze disclosed information regarding the placing to another shareholder and instructed his own broker to sell his entire shareholding, at any price.

As might be expected, once the discounted placement was announced, the company's share price fell dramatically. However, Mr Breeze had succeeded in disposing of at least part of his shareholding by that time, enabling him to avoid a loss in respect of those shares.

Mr Breeze was fined £59,557; he received a 15% discount for agreeing to settle at the earliest opportunity, and for proactive cooperation with the FCA's investigation. He was also publicly censured by the FCA, and ordered to pay restitution amounting to £1,850, plus interest, to the individuals who bought his shares at a higher price than they would have done, had the information known to Mr Breeze been public.

FCA commences proceedings against investment portfolio manager at Blackrock

Mark Lyttleton, 2 November 2016

The FCA has commenced criminal proceedings against Mark Lyttleton, a former investment portfolio manager at Blackrock Investment Management (UK) Ltd. Mr Lyttleton was charged with insider dealing, in connection with offences relating to trading in equities and a call option in 2011, and pleaded guilty to two counts of insider dealing on 2 November 2016. He will be sentenced on 21 December 2016.

FCA imposes penalties on Sonali Bank (UK) Limited and its former money laundering reporting officer for serious AML failings

Sonali Bank and Steven Smith, 12 October 2016

The FCA has fined Sonali Bank (UK) Limited (SBUK) £3,250,600 and imposed a 168-day business restriction, preventing it from accepting deposits from new customers. The FCA also took action against the bank's former money

laundering reporting officer (MLRO), Steven Smith, by imposing a fine of £17,900 and prohibiting him from performing the MLRO or compliance oversight functions at regulated firms.

Despite having previously received clear warnings about serious weaknesses in its anti-money laundering (AML) governance and control systems, the FCA found that SBUK had failed to maintain adequate AML systems between August 2010 and July 2014.

SBUK were found to have breached two of the FCA's Principles for Businesses:

- Principle 3 (Management and Control) – by having serious and systemic weaknesses in its AML controls, SBUK breached this Principle 3. The FCA found that the weaknesses extended to almost all levels of SBUK's business and governance structure, including its senior management team, MLRO function, oversight of branches, and AML policies and procedures. As a result, SBUK failed to comply with its operational obligations in respect of customer due diligence, the identification and treatment of politically exposed persons, transaction and customer monitoring and making suspicious activity reports; and
- Principle 11 (Relations with regulators) – while under FCA investigation, SBUK breached Principle 11 by failing to notify the FCA, for at least seven weeks, that a significant fraud had been alleged. SBUK should have notified the FCA on this matter immediately under SUP 15.3.17R.

SBUK was fined £3,250,600, of which £3,110,600, imposed as a result of SBUK's breach of Principle 3, was subject to an uplift of 20% due to aggravating factors; namely that SBUK had been on notice of various weaknesses in its AML systems and controls for four years and that the firm had access to a considerable amount of public guidance relating to AML regulatory requirements.

As regards the Final Notice against Mr Smith, the FCA found that he had breached Principle 6 (Due skill, care and diligence in managing the business) of the FCA's Statements of Principle and Code of Practice for Approved Persons and that he was also "knowingly concerned" in SBUK's breach of Principle 3.

The FCA also found that Mr Smith demonstrated a "serious lack of competence and capability". Despite repeated warnings from the SBUK's internal auditors, Mr Smith reassured SBUK's board and senior management that AML controls were working well when they were not. Mr Smith failed to:

- put in place appropriate AML monitoring arrangements;
- identify serious weaknesses in operational controls and a lack of appropriate knowledge among staff;
- appropriately report concerns from SBUK internal auditors and the results of internal testing; and
- impress upon senior management the need for more resources in the MLRO function.

Whilst the FCA did acknowledge Mr Smith's lack of senior management support and that he was faced with "significant challenges" at work, the FCA noted that he failed to take potential steps open to an MLRO in such a position. These options included escalating concerns, appropriate reporting in annual MLRO reports, or reporting concerns to the FCA. This guidance resembles that of the FCA in its final notice issued to Peter Johnson, former compliance officer of Keydata Investment Services Ltd, which is discussed below.

Mr Smith's fine of £17,900 was subject to an increase of 10% which was applied as an aggravating factor given that he was aware of the FSA's feedback after its visit to SBUK in 2010 and that the FSA and FCA have issued guidance in this area.

This decision is a reminder that action against firms without robust and risk-focused AML systems remains high on the FCA's agenda. The penalties show that the FCA had an appetite to take enforcement action against both firms and the senior individuals who do not meet the FCA's standards. This is wholly in line with the FCA's new regime, and its increasing focus on personable accountability.

The decision is also a reminder that enforcement action by the FCA may include exercising its powers to restrict a firm's continuing business. This approach by the FCA is likely to continue. In its Business Plan for 2016/17, the FCA indicated that it would specifically consider imposing business restrictions on firms that are found to have weaknesses in their financial crime controls. It may be that financial penalties alone are not considered to be a sufficient deterrent in certain cases.

Prohibition order in connection with unauthorised collective investment scheme

Scott Crawley, Daniel Forsyth, Adam Hawkins, Ross Peters, Aaron Petrou and Dale Walker, all 1 November 2016

The FCA has published Final Notices in respect of six individuals in connection with their role in operating an unauthorised collective investment scheme through three companies: Plott Investments, European Property Investments and Stirling Alexander. The scheme involved over 100 investors, with losses of around £4.3 million. The individuals were also convicted of offences including conspiracy to defraud, and possession of criminal property, and between them sentenced to over 30 years' imprisonment.

Charges in connection with alleged boiler room fraud

Charanjit Sandhu, 18 November 2016

In November 2016, following an investigation by the FCA, Charanjit Sandhu was charged with conspiracy to defraud in connection with the promotion and sale of shares in Atlantic Equity LLC.

Mr Sandhu is the sixth individual to be charged with conspiracy to defraud in connection with Atlantic Equity LLC. In June 2016, five other individuals were also charged. The offences, in each of the six cases, relate to a series of four boiler room companies, through which the defendants promoted investment schemes offering investors interests in a purported commercial development in Madeira. In total, 175 investors lost in the region of £2.75 million as a result of the fraud.

Two plead guilty to insider dealing in relation to takeover of Logica Plc

Manjeet Mohal and Reshim Birk, 30 November 2016

On 30 November 2016, the FCA confirmed that it had been successful in bringing a case against two individuals who pleaded guilty to three counts of insider dealing in connection with the proposed takeover of Logica Plc (Logica) by CGI Holdings (Europe) Ltd (CGI). Manjeet Mohal, a long-standing member of the management reporting team at Logica, came into possession of inside information during takeover negotiations between the firms. He pleaded guilty to two counts of the illegal disclosure of that information. Reshim Birk, a neighbour of Mr Mohal, also pleaded guilty in respect of one count of insider dealing. He admitted that his purchase of shares and options in Logica, just two days before the public announcement regarding the takeover, was informed by information provided by Mr Mohal. The FCA's investigation previously resulted in the prosecution of two others for insider dealing in connection with the same takeover.

Complaints

PPI Complaints: Further FCA Consultation Paper and Policy Statement

Consultation Paper 16/20, 2 August 2016

The FCA has published a further consultation paper concerning changes to its rules in relation to complaints in connection with PPI. The FCA has confirmed that it believes the overall package of proposals set out in its earlier Consultation Paper (CP15/39) should be taken forward, including the launch of a consumer communications campaign in order to raise awareness of issues around PPI complaints.

However, the FCA has changed the deadline for new PPI complaints which was proposed in CP15/39. In CP 16/20, the FCA maintained its view that a deadline should be imposed by which consumers would need to make their PPI complaints, or lose their right to have the complaint assessed by firms or the Financial Ombudsman Service. CP15/39 proposed a deadline of December 2018, which was extended in CP16/20 until approximately June 2019 – two years after the new rules come into force, which is expected to take place in June 2017.

This proposed timeline is likely to be subject to further change. The FCA set out in CP16/20 that this timing was dependent on publication of its proposed rule changes in December 2016 and, on 9 December 2016, announced that it would be unable to meet that deadline in light of the volume of feedback received to CP16/20.

Various stakeholders, including perhaps unsurprisingly a number of claims management companies, have indicated that they will seek judicial review of any decision by the FCA to proceed with the rules proposed in CP15/39. If that challenge goes ahead, any potential rule changes could be substantially delayed.

In addition to the proposed deadline for PPI complaints, in CP15/39 the FCA explained that it considered that the decision in *Plevin v. Paragon Personal Finance Ltd* [2014] UKSC 61 had created uncertainty for firms about how the judgment should be taken into account in the context of PPI complaints, bringing about a risk of inconsistent, and potentially unfair, outcomes for complainants. As such, the FCA decided to intervene with rules and guidance about how firms should handle PPI complaints in light of Plevin. The main changes are that the FCA now proposes to:

- include profit share sums in the FCA's approach, in addition to commission;
- clarify how the FCA's approach will work where commission, and now profit share rates, vary during the life of the PPI policy; and
- provide that sums rebated to a consumer when they cancelled a single premium PPI policy early can be partly included in, and so reduce, any redress due.

The FCA considers that these changes and clarifications will lead to significantly more redress being paid by firms, relative to its original proposals, for complaints concerning undisclosed commission along the lines of Plevin. However, these changes should not increase the total PPI redress to the same degree, since most complaints will still concern mis-selling and be redressed on that basis under the FCA's existing rules.

The consultation closed on 11 October 2016. A further announcement will be made by the FCA in Q1 2017.

Benchmarks

Final Notice on LIBOR submitter at Barclays

Peter Johnson, 26 August 2016

The FCA has published its Final Notice in respect of Peter Johnson, former USD LIBOR submitter at Barclays, following Mr Johnson's withdrawal of his reference to the Upper Tribunal. In July 2016 Mr Johnson, following a guilty plea, was sentenced to four years in prison for conspiracy to defraud.

European Commission decision on yen interest rate derivatives

European Commission Decision

On 23 September, the European Commission published its decision on the yen interest rate derivatives cartel case. The Commission found that traders from UBS, JP Morgan, CitiGroup, Deutsche Bank and RBS had engaged in various anti-competitive practices, the object of which was the restriction and/or distortion of competition. In particular, certain traders had colluded on submissions for JPY LIBOR, and had exchanged commercially sensitive information. Further, the Commission determined that broker RP Martin had facilitated one of the competition infringements. A total fine of €680 million has been imposed.

European Commission fines Credit Agricole, JP Morgan Chase and HSBC

European Commission Decision

On 7 December, the European Commission confirmed its decision to fine Credit Agricole, JP Morgan Chase and HSBC a total of €485 million for participating in a cartel concerning the pricing of interest rate derivatives. The commission accused the banks of exchanging sensitive information and colluding on Euro interest rate derivative pricing elements – that is, the manipulation of EURIBOR and/or EONIA. Four other banks reached a settlement with the commission concerning the same issues in 2013. Credit Agricole has indicated that it will appeal the decision.

FMLC response to ESMA consultation on technical standards under Benchmark Regulation

FMLC Response

In our previous edition of this Update, we summarised the Consultation Paper published by ESMA on 27 May 2016 on a compromise text for the Benchmarks Regulation. The Financial Markets Law Committee (FMLC) has now published its response, dated 1 December 2016. The FMLC has raised a number of concerns, including in relation to the positioning of the oversight function. The Consultation Paper refers to the importance of ensuring effective challenge of the management body which is, in essence, the board of the administrator of the benchmark. In some circumstances, that board may delegate management to operational and executive staff. The FMLC, therefore, has recommended that the draft regulatory technical standards reflect this possibility, such that the oversight function shall be in a position to challenge not only the decisions of the management body but also of any staff of the administrator to whom the management body has delegated responsibility.

FCA publishes Enforcement Annual Performance Account for 2015/16

Continued focus on individual accountability

[FCA's Enforcement Annual Performance Account]

On 12 July 2016, the FCA published its annual report for 2015, including its annual enforcement performance account. Interestingly, the report reveals a decline in the value of financial penalties imposed by the FCA, which, in the period ending 31 March 2016, fell to £884.6 million, as compared with £1.4 billion in the previous period. This may represent a slightly softer approach to enforcement or, as is more likely, the resources absorbed during this period in large-scale investigations into issues such as FX manipulation.

It remains to be seen whether financial penalties will rise in the next period once these internal resources have been redirected.

The account also reflects the FCA's increasing focus on individual accountability; 17 fines were issued in this period, totalling £4.2 million, prohibition orders were imposed on 24 people and there were also eight criminal convictions for unauthorised business.

Other developments

Identification of individuals in final notices: Grout

Julian Grout v. the Financial Conduct Authority [2016] UKUT 0302 (TCC)

In July 2016, the Upper Tribunal published its decision in respect of the reference made by Mr Grout, in which he alleged that he had been identified in a final notice issued by the FCA in September 2013 in connection with the London Whale trades. Mr Grout alleged that he had not been given the opportunity to contest the prejudicial statements made in the final notice which effectively identified him.

It was common ground that the question of whether Grout had been "identified" in the final notice should be answered in accordance with the construction of s.393 FSMA which the Court of Appeal set out in its judgment in *FCA v. Macris* [2015] EWCA Civ 490.

Here, the Tribunal found that, although Grout had not been named in the final notice, he had nonetheless been identified and the *Macris* test had been satisfied. Further, some of the relevant

sections of the final notice were prejudicial to Grout.

The decision provides a helpful summary by the Tribunal of the relevant test in *Macris*. That is, there must be a separate reference to a specific person in relation to the matters identified in the notice, a "key or pointer" to a particular person other than the recipient of the notice. This is a two-stage test, which requires:

- firstly, the identification of a specific "pointer" involves considering whether the relevant statements in the notice which are said to identify the third party do refer to "a person" other than the recipient of the notice. That test should be carried out without reference to external material; and
- secondly, whether the "pointer" identified is a pointer to the third party (in this case, Grout). This can be determined by reference to external material but, as set out in *Macris*, such material must be limited to that which objectively would be known by persons acquainted with the third party or persons operating in the relevant area of the financial services market.

In this case, it was determined that the description "traders on the SCP" (Synthetic Credit Portfolio) was sufficiently specific to identify Grout.

The FCA has been given permission to appeal the Grout decision to the Court of Appeal. The proceedings themselves have been stayed until the release of the Supreme Court's judgment in *Macris*, which was heard on 13 October 2016, and judgment is awaited.

Correspondence between FCA and PRA on disclosure of supervisory information

[Treasury Select Committee correspondence]

The UK's Treasury Select Committee (TSC) has published correspondence in which it calls for the PRA to make public the information provided to it by firms in its supervisory capacity – or explain why it should be kept secret. The correspondence forms part of a wider exchange between Andrew Tyrie MP and Andrew Bailey, then Chief Executive Officer of the PRA, following Mr Tyrie's request, in December 2015, that the PRA provide an average of the required capital ratios of the incumbent banks in contrast to new entrants.

In a letter dated 6 June 2016 the TSC raised concerns regarding issues including resolution and bail-in as well as the increasing intrusiveness of the PRA's regulation, which raised the potential danger that the PRA could be regarded as a shadow director. In its response, dated 30 June 2016, the PRA explained why it did not consider that the actions it takes in the proper discharge of its statutory duties could result in it being regarded by the court as a shadow director, within the meaning of the Companies Act 2006.

Also in its letter of 6 June 2016, the TSC has set out its concerns regarding what it refers to as the "doctrine of supervisory confidentiality". That is, the fact that a significant volume of information is provided by banks to their regulatory supervisors which remains confidential. The information is available to certain board members and employees within the bank, and staff within the regulatory body, but shareholders, holders of debt securities and depositors have no such access. Restricting the ability of these groups to obtain information relevant to investment decisions inevitably makes it more difficult for them to make good decisions in that respect.

A key concern is likely to be that bondholders, in particular, have access to as much information as possible. The TSC has stated the level of market discipline imposed by shareholders before the crisis was found to be deficient and that it is hoped that after the development of bail-in debt, bondholders will do better.

The TSC considers that "*regulatory convenience allies with the commercial advantages of non-disclosure, to the dis-benefit of investors, consumers and taxpayers*", and a measure of "*secrecy*" by the regulator where, as set out in the press release accompanying the publication of the correspondence, a "presumption of disclosure" (albeit with some, clearly defined, exemptions) would be more appropriate. The TSC proposed that if more supervisory information was made public then the market mechanism for imposing good behaviour on banks might work more efficiently. The wider context of the increased intrusiveness and complexity of the supervisory process has, in the view of the TSC, merely served to strengthen the case for greater disclosure.

The PRA responded, in its letter of 30 June 2016, to explain why it was confident that there is currently an appropriate balance between regulatory confidentiality and public disclosure. The PRA has taken steps to increase transparency, including by the disclosure of stress scenarios, methodologies and the results of annual stress tests of the large UK banks. Nevertheless, in the press release which accompanied the release of this correspondence, Mr Tyrie mantained that the PRA should consider setting out a disclosure policy to enable the merits of supervisory confidentiality to be judged on a consistent and transparent basis.

HMT consultation on amending the RAO definition of financial advice

HMT consultation

On 20 September 2016, HM Treasury (HMT) published a consultation paper in which it proposed amending the definition of "financial advice", set out in article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order (RAO).

We summarised in our previous edition of this Update the final report of the Financial Advice Market Review (FAMR), which provoked considerable interest in highlighting the difficulties faced by consumers in seeking to access good quality advice. The FAMR report set out a number of recommendations, one of which was to amend the definition of "regulated advice" to correspond with the provision of a personal recommendation as set out in MiFID.

The definition of "investment advice" under MiFID is narrower in scope than "advising on investments" under article 53 RAO, since the MiFID definition requires the advice to be of a personal nature, while article 53 does not.

This Consultation Paper sets out HMT's proposed approach to that issue, and text for the amended article 53. HMT acknowledges the potential risk to consumers of moving the regulatory boundary, which would enable some firms to provide guidance services, for which they currently require authorisation, without being authorised. However, HMT highlighted that where a guidance activity is related to a regulated product, there are already restrictions in place to prevent consumer detriment. These include, for example, the rules limiting inducements that a regulated firm can make to a third party, including unregulated firms, and restrictions around financial promotions.

HMT also considers that the proposed amendment may be beneficial in providing greater certainty, enabling firms to better understand their regulatory requirements. The FAMR consultation indicated that some firms had deliberately avoided providing information to support customer decision-making, for example around the merits and risks associated with particular investments, due to a lack of clarity around what constitutes regulated advice and what is perceived to be the blurred boundary between providing consumers with helpful guidance and unintentionally straying into an implicit personal recommendation. To avoid inadvertently straying into the provision of regulatory advice, firms have stepped back from providing support to consumers – which itself increases the risk that consumers will make uninformed, and almost inevitably poor, investment decisions.

Article 53 RAO applies to insurance as well as investments. As such, any change to the definition of "advising on investments" is likely to have a significant impact on any financial services firm which provides advice to consumers.

The Consultation closed on 15 November 2016 and a summary of responses is awaited. HMT and the FCA have agreed that further guidance will be required as to firms' responsibilities in designing and delivering guidance services; that is, providing helpful guidance to consumers which does not constitute regulated advice.

FCA's partial ban upheld for fund manager's failure to spot market manipulation

Tariq Carrimjee v. FCA [2016] UKUT 0447 (TCC)

On 20 October 2016, the Upper Tribunal upheld the FCA's decision to ban Tariq Carrimjee of Somerset Asset Management from carrying out the compliance oversight and money laundering reporting significant influence functions.

Mr Carrimjee was an investment and fund manager responsible for the firm's compliance oversight. The FCA determined that Mr Carrimjee had failed to act with due skill, care and diligence in failing to escalate the risk that a particular client of his might have been intending to engage in market manipulation. The FCA considered that Mr Carrimjee had suspected that market manipulation was the client's goal, but had turned a blind eye to the risk of market abuse and recklessly assisted his client in attempting to achieve that goal.

FCA interim report on the asset management market published

MS15/2.2 – interim report

On 18 November 2016, the FCA published its interim report on the asset management market study, which was launched in November 2015.

The FCA's findings suggest that there is weak price competition in a number of areas of the asset management industry, which has a material impact on the investment returns of investors through their payments for asset management services.

The FCA's analysis shows that mainstream, actively managed fund charges have stayed broadly the same over the past 10 years; few firms lower charges in order to attract investment, particularly in the retail sphere. Firms appear reluctant to undercut one another by offering lower charges, and prices do not appear to fall as fund size increases – which suggests that the economies of scale are captured by the fund manager, without being passed onto the investor.

Charges for passive funds, however, have fallen over the past five years. The FCA considers that this, combined with the overall growth of passive investing, suggests price awareness and competitive pressure on prices is building among certain groups of investors.

The FCA's analysis also indicated that actively managed investments do not outperform their benchmark after costs. Funds which are available to retail investors underperform their benchmarks after costs, while products available to larger, institutional investors achieve returns that are not significantly above the benchmark.

Further, there does not appear to be a clear correlation between price and performance; the most expensive funds do not necessarily do better than less expensive funds, after costs, and many active funds offer similar exposure to passive funds, while charging significantly more.

The FCA also concluded that there are persistent issues around transparency of pricing, particularly around transaction costs, about which investors are not given information in advance, as a result of which they cannot take into account the full cost of investing when making their initial decision.

Accordingly, the FCA has set out a number of proposals to boost competitive pricing, for both retail and institutional investors. The FCA is provisionally proposing changes including, most notably, an all-in fee approach to quoting charges, so that fund investors can see more easily what is being taken from the fund and more easily compare potential investments. The FCA has set out four ways in which such a charge could work, including:

- the current ongoing charges figure (OCF) becomes the actual charge taken from the fund, with any variation between the OCF, which is an estimate, and the actual ongoing charges, covered by asset managers;
- the current OCF becomes the actual charge, with managers providing an estimate of any implicit and explicit costs. This would, in essence, be the same as the above approach, but would require asset managers to estimate transaction costs, which are not currently included in the OCF, which would enable easier comparison of the likely charges across different funds;
- a single charge including all charges and transaction costs, with an option for overspend. That is, the single charge would cover all costs, but the asset manager would have discretion to take additional transactional charges from the fund in exceptional circumstances, which would then be explained to investors in the annual statement; and
- a single charge including all charges and transaction costs, with no option for overspend. This would bind the asset manager to a single figure, including transaction costs. This approach would result in the asset manager bearing the risk of a difference between forecast and actual trading costs.

The FCA has acknowledged that some asset managers would respond to such proposals by simply increasing the single charge to cover the increased risk which they would bear under the proposals outlined above. The FCA considers that competition may, to a certain extent, provide sufficient pressure such that a single charge approach would not result in an increase in charges paid by investors.

However, the introduction of a single, all-in fee is likely to increase the risk that asset managers will indeed increase overall fees. Estimating transaction fees in advance is likely to be costly and complex, and may require firms to allow for a margin to cover costs which are higher than expected, to avoid covering that cost themselves. Whilst the FCA's focus on increased transparency is likely to prove uncontroversial, it will be interesting to see how the asset management market responds to the FCA's proposed approach and the criticism of current funding structures.

The FCA is currently seeking views about its interim findings, which should be submitted by 20 February 2017.

FCA Consultation Paper on Contracts for Difference

CP16/40, 6 December 2016

The FCA has published CP16/40, which addresses conduct of business rules for firms providing contracts for difference (CFDs) to retail clients. The Consultation Paper highlights the FCA's concern that CFDs are complex, leveraged derivative financial instruments, currently offered to retail clients through online platforms, in relation to which the FCA's supervisory work and thematic reviews have found increasing instances of poor conduct and risk of consumer detriment. The FCA's sample of client data suggests that 80% of clients lost money on CFDs over the past 12 months, with the average loss amounting to £2,200.

Perhaps unsurprisingly, the FCA is proposing a range of policy measures to improve investor protection and limit the risks posed to retail investors by CFDs. This includes enhanced disclosure requirements, as part of which all retail CFD firms will be required to provide a standardised risk warning, and mandatory profit-loss disclosures, to better illustrate the risks which CFDs entail.

Further, the FCA has proposed leverage limits, including lower leverage limits for retail clients with less than 12 months' active trading experience in similar products, with higher limits for more experienced clients. CP16/40 refers to a leverage maximum of 25:1 for inexperienced retail clients, and 50:1 for more experienced clients. The FCA cites current practice of offering retail clients leverage in excess of 200:1, which requires the client to post only 0.5% of their notional exposure; in this context, the FCA's proposals are likely to have a substantial impact on spread-betting firms.

The deadline for responses to the Consultation Paper is 7 March 2017.

FSCS funding review

Treasury Select Committee correspondence

The FCA has confirmed that it intends to publish a consultation paper regarding FSCS funding by the end of December 2016.

In correspondence with the Treasury Select Committee, released on 31 October 2016, the FCA confirmed that it has consulted a range of stakeholders, including consumer groups and industry associations, and intends to review the FSCS funding model, with a view to improving affordability for firms without reducing consumer protections. This may involve merging particular funding sub-classes, and potentially introducing risk-based levies in relation to the products or services offered by a firm, its capital reserves or reported complaints against it. The FCA has also indicated that it will review the relationship between FSCS funding and professional indemnity insurance, and in particular the FCA will consider whether a separate review is required of the professional indemnity insurance market.

PRA's functions transfer to Bank of England

On 7 December 2016, HM Treasury confirmed that it intends to transfer the PRA's functions to the Bank of England on 1 March 2017. Pursuant to the Bank of England and Financial Services Act 2016, a new committee, the Prudential Regulation Committee, will be established with the purpose of exercising the functions of the Bank of England in its role as the PRA.


Premium
Volume
-0.68%
-0.33%
-0.36%
-0.50%
-64
21114
-75
212
18590 (1)
18560 (5)
18514 (2)
18440
18357

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