




LATHAM & WATKINS

12 February 2020

Financial Regulation Monthly Breakfast Seminar

Overview

- 
- The recent series of FCA “Dear CEO” letters, including those relating to asset managers and financial advisers
 - The Bank of England, PRA and FCA’s joint publications on their recommended next steps for LIBOR transition
 - The French AMF’s report on research in the wake of MiFID II and its observations, identified issues and recommendation
 - FCA Insight Article: “Turning Data Inside Out”
 - The FCA Call for Input on open finance and extending open banking principles to cover a wider range of financial data
 - ESMA’s consultation papers on MiFIR pre-trade transparency for equities and systematic internalisers active in non-equity instruments



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The recent series of FCA “Dear CEO” letters,
including those relating to asset managers and
financial advisers
Anne Mainwaring

FCA Dear CEO Letters

FCA: “As set out in our **Approach to Supervision**, we assign firms to a portfolio based on their primary business model. We regularly analyse each portfolio and agree a strategy to take **pre-emptive action on firms and issues posing the greatest harm**”

2020

6 January: Non-Financial Misconduct in Wholesale General Insurance Firms

20 January: Alternatives Supervision Strategy

20 January: Asset Management Supervision Strategy

21 January: Portfolio Strategy Letter for Financial Advisors

24 January: Benchmark Administrators – Supervisory Strategy

6 February: Portfolio Strategy Letter for Platforms

FCA Dear CEO Letters: Supervisory Priorities

- Brexit
 - Consider how EU exit will impact you
- SMCR
 - FCA reviewing implementation for second wave firms
- LIBOR transition
 - Sep 2018 Dear CEO Letter on LIBOR transition – all regulated firms should read this
- Operational resilience
 - CP19/32 on Operational Resilience
- Product governance
 - Work to assess how well product governance has been embedded will complete in early 2020 (asset management sector inc. host ACDs)

FCA Dear CEO Letters: Asset Managers

- Progress needed for the sector to deliver the objective of acting in the best interests of customers
- Standards of governance fall below the FCA's expectations
 - SMCR implementation to be looked at in first half of 2020
 - Boards of regulated entities must engage in robust discussion and challenge, without undue reliance on group structures
 - Recognise and take action to mitigate harm caused by conflicts of interest between affiliates (especially where host ACDs feel unable to exert challenge for fear of loss of revenue)
 - Funds offered to retail investors do not consistently deliver good value – usually due to a failure to identify conflicts of interest
 - Inadequate investment in technology and operational resilience risks loss of sensitive data or harm to market integrity

FCA Dear CEO Letters: Asset Managers

- Asset Management Market Study (AMMS)
 - Rule changes resulting from AMMS are now in effect
 - Conduct value assessments on authorised funds – are boards meaningfully challenging costs, fees, product design; are fees higher than returns
 - The FCA is continuing to focus on the delivery of poor value by “closet trackers”
 - A quarter of governing bodies of AFM entities should be independent (plus at least two independent directors)
 - Are product disclosures fair, clear and not misleading?
 - The FCA will publish metrics on long-term underperforming active funds and trends within the sector (via Annual Business Plan)

FCA Dear CEO Letters: Alternative Investment Firms

- Concerns that high risk alternative investments are being made available to less sophisticated (retail) investors
- Suitability / appropriateness tests may not be adequate in the case of alternative investments
- The FCA will review retail market exposure to a broad range of alternative investment product types – do firms take steps to make sure that investors adequately understand the risks of investment?
- CASS oversight and controls are not robust
- Weak systems lead to market abuse, financial crime or market disruption
 - Market disruption: Very high risk management strategies with significant leverage requires high quality risk management controls
 - Financial crime: Alternatives firms must be alert to the risk that they could be used to facilitate financial crime

FCA Dear CEO Letters: Financial Advisers

- Three key ways consumers of financial advice may be harmed:
 - Receiving unsuitable advice for their needs and objectives
 - Falling victim to pension and investment scams
 - Not receiving redress as a result of the non-payment of FOS awards and / or failing firms being unable to pay customers – inadequate financial resources or insufficient PI coverage (check exclusions)
- Increased supervisory focus on these areas in the next two years
- Assessing Suitability Review 2
 - Focus: Initial and ongoing advice on taking an income in retirement (following pension freedom reforms)
 - Look out for final rules on July 2019 consultation in Q1 2020

FCA Dear CEO Letters: Platforms

- Technology and operational resilience
 - Business continuity issues resulting from insufficient investment, processes and resources for technology and operations
 - Change management
- Third party outsourcing
 - Inadequate governance and oversight, risk management and clear contractual arrangements with third party outsourcers raises operational resilience risks
 - Reviews of outsourcing arrangements
- Conflicts of interest
 - Best buy lists
- Investment Platforms Market Study
 - Implementation of findings in IPMS Final Report (March 2019)

FCA Dear CEO Letters: Benchmark Administrators

Harm	FCA action
Poor benchmark design	<p>FCA: Will undertake its own review over the next two years which will include on-site visits</p> <ul style="list-style-type: none"> • Poor quality input data • Lack of sufficient surveillance • Conflicts not appropriately managed • Benchmarks being manipulated
Market disruption	<p>FCA: We will review a sample of recalculation and cessation policies to ensure that transparent and accurate information is provided to users and provide feedback where it deems improvements necessary</p> <ul style="list-style-type: none"> • Poorly managed cessations / recalculations • Lack of clarity for users on cessations / recalculations • Lack of alternative benchmarks
Benchmark statements	<p>FCA: We intend to undertake our own review of Benchmark Statements and assess their compliance ... We will contact you if we have reviewed your statements and believe improvements are necessary</p>
User access	<p>Customers paying excessive fees and charges resulting from high costs of switching, complex licensing arrangements and a preference for customers to use established benchmarks Links to Wholesale Sector Competition Review and the Asset Management Market Study</p>

A blue-toned background image featuring a financial line chart with multiple data series and a grid. The chart shows various peaks and troughs, suggesting market volatility. The overall aesthetic is professional and data-oriented.

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The Bank of England, PRA and FCA's joint
publications on their recommended next steps for
LIBOR transition
Becky Critchley

LIBOR transition

- On 16 January 2020, the Working Group on Sterling Risk-Free Reference Rates, Bank of England and FCA jointly published a set of documents, outlining priorities and milestones for 2020 on LIBOR transition
- *“The Working Group’s priorities and roadmap for 2020”* gives a timeline of the Working Group’s top 2020 priorities, including:
 - Cease issuance of GBP LIBOR-based cash products maturing beyond 2021 by end Q3 2020
 - Take steps throughout 2020 to promote & enable widespread use of SONIA compounded in arrears
 - Take steps to enable a further shift of volumes from GBP LIBOR to SONIA in derivative markets
 - Establish a clear framework to manage transition of legacy LIBOR products, to significantly reduce the stock of GBP LIBOR referencing contracts by Q1 2021
 - Provide market input on issues around “tough legacy” contracts
- A factsheet for end-users summarising LIBOR transition and setting out why market participants need to act now

LIBOR transition – FCA and PRA statements

- The Bank and FCA have published two documents designed to further catalyse transition efforts:
 - A letter from the FCA and the Bank to major banks and insurers setting out initial expectations of firms' transition progress during 2020
 - A statement encouraging market makers to switch the convention for sterling swaps from LIBOR to SONIA on 2 March 2020, designed to help progress transition in the derivatives market

LIBOR transition – Development of a forward-looking term SONIA reference

- *“The use cases of benchmark rates: compounded in arrears, term rate and further alternatives”*
 - Sets out the views of the Term Rate Use Case Task Force on the appropriate use of SONIA compounded in arrears for businesses and clients
- Good progress made in developing a forward looking TSRR
 - First published for an observational period Q1 2020
 - Published for use Q3 2020
- Use of a TSRR will be limited
 - Regulators have expressed their preference for transition to SONIA compounded in arrears
 - Identify a number of product markets and users where SONIA compounded in arrears is not appropriate
 - TSRR may be the most appropriate solution for ‘tough legacy’ contracts

LIBOR transition – bond transition by way of consent solicitation

- “Progress on the transition of LIBOR-referencing legacy bonds to SONIA by way of consent solicitation”
 - A statement considering helpful ‘lessons learned’ from recent conversions of legacy LIBOR referencing bonds to SONIA
 - Designed to encourage transitioning more English law legacy floating rate notes from LIBOR to SONIA by way of consent solicitation

LIBOR transition – bond transition by way of consent solicitation

- Sets out six considerations:
 - While market precedents are helpful, each issuer and each bond is unique
 - Given the interest of both issuers and investors in removing exposure to LIBOR risks, consent solicitations undertaken for this purpose have not typically involved the payment of consent fees
 - To facilitate open dialogue, the issuer may consider it appropriate to pre-announce a consent solicitation by way of an RNS announcement
 - The principal aim of these consent solicitations is transition to a replacement RFR. Seeking to make other amendments at the same time may prejudice this aim
 - Parties should consider the implications of any delay between the date on which the extraordinary resolution is passed and the pricing date for any adjustment spread since market prices may move
 - It is essential to have regard to the timing deadlines specified in the bond documentation

LIBOR transition – summary of highlights

- Regulated firms should work on the basis that “[t]he intention is that sterling LIBOR will cease to exist after the end of 2021. No firm should plan otherwise”
- Issuance of GBP LIBOR-based cash products maturing beyond 2021 should cease by the end of the third quarter of 2020
- SONIA compounded in arrears is expected to become the market convention for GBP interest rate swaps from 2 March 2020
- A forward-looking TSRR rate will likely be available for use by the market in Q3 2020, however, its use is expected to be limited compared to the SONIA compounded in arrears rate
- Market participants are encouraged to transition LIBOR-linked "legacy" bonds and guidance around the consent solicitation process



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The French AMF's report on research in the wake of
MiFID II and its observations, identified issues and
recommendation
Rob Moulton

The AMF's approach

- *“The reform was introduced without political debate nor a preliminary impact analysis...contrary to the normal procedures for enactment of European legislation. The lack of an analysis meant it was not possible to take the specific features of each country into account, notably with regard to corporate brokerage in the UK”*
- *“Drops in revenue thus far often range between 20% and 30% on average, and up to 50% in some cases”*
- *“The Regulation did not really define its fundamental rules, especially with regard to price competition...This shortcoming had the consequence of destabilising the competitive position of European firms”*

Proposal 1 – A new research market place

- The supply of research services at “extremely low prices” is “detrimental to a healthy competitive environment” and a “form of adequation between the price and the cost of production” should be introduced at a European level and in the AMF’s guide
- Introduce a French “virtual research marketplace” where investors volunteer to share costs and pay a market price for small, medium and IPO stocks provided by firms producing such research
- Provide financial support (via Bpifrance) to research providers covering innovative companies

Proposal 2 – Develop Sponsored Research

- Call it “research paid for by the company”
- Introduce a self-regulatory framework to cover disclosures, conflict management, standard terms
- Permit broad distribution

Proposal 3 – Adjust existing framework

- Introduce concept of “reasonable commercial basis” for payment as a requirement
- Assume corporate access is a minor non-monetary benefit and not a possible inducement
- Extend trial period to 6 months in each 12 month period
- Exemptions from MiFID for smaller managers, research boutiques, and research on smaller companies
- (Perhaps) only regulate as an inducement research provided at a “clearly undervalued” price



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FCA Insight Article: “Turning Data Inside Out”
Rob Moulton

The Market Abuse Regulation and FCA's MAR Rules

- MAR 1.2.12 the following factors may be taken into account
 - (3) Whether the information is otherwise generally available...(including if it is only available on payment of a fee)
 - (4) Whether the information can be obtained by observation by members of the public without infringing rights or obligations of privacy, property or confidentiality
 - (5) [NOW DELETED] The extent to which the information can be obtained by analysing or developing other information which is generally available

Questioning the approach to alternative data

- User may have difficulty knowing that the data was gathered lawfully, and whether consent for use for investment purposes should have been obtained (especially for “exhaust data”)
- Data may be so complex or expensive that it produces an asymmetry
- *“Insider dealing consists of an unfair advantage...is there a shared view between the market and regulators on what constitutes an unfair advantage?...we need more data and more analysis and a debate”*

A blue-toned background image of a financial line chart. The chart features a grid of dashed lines and a solid line that fluctuates across the grid, representing data points over time. The overall aesthetic is professional and data-oriented.

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The FCA Call for Input on open finance and extending open banking principles to cover a wider range of financial data

Stuart Davis

Background: Open Banking

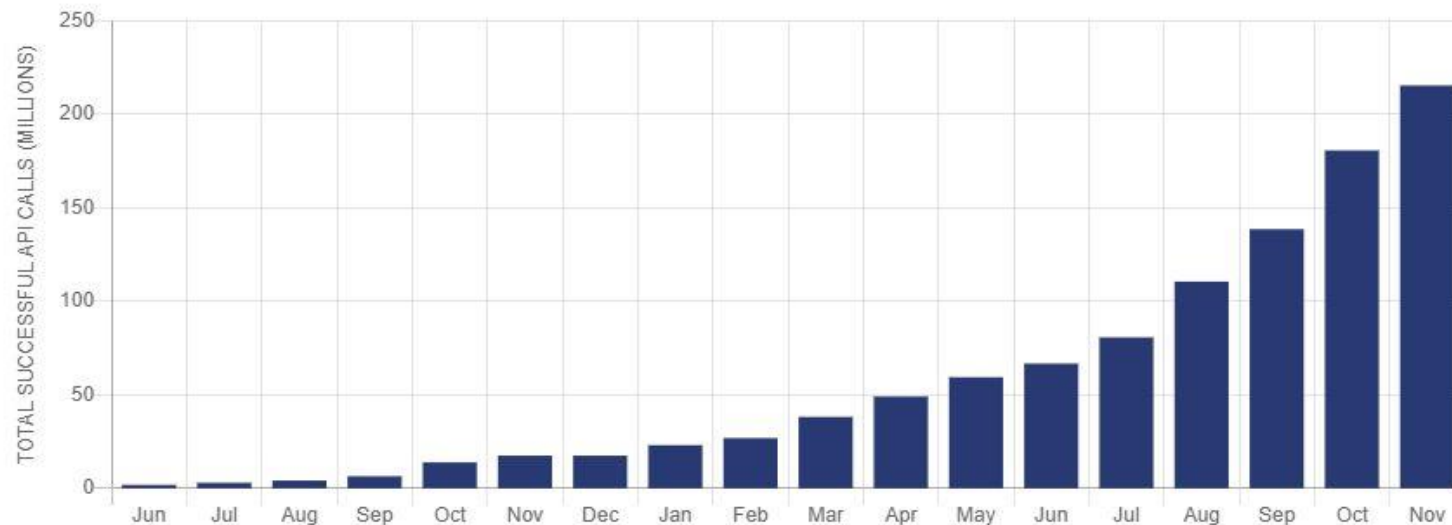
- Open Banking: Mandated under PSD2 and came into force in September 2019
 - Applies to payment accounts held at any EU bank, e-money issuer or payment institution (the Account Provider)
 - Customers can consent for their data to be shared with licensed third party service providers (TPPs)
- Account Providers required to provide an interface for TPPs to access:
 - Data relating to the payment account
 - Payment functionality attached to the account
- Through open APIs or a modified version of the existing customer interface

Background: Open Banking

- 135 new FCA authorised TPPs
- Steady increase in the use of APIs under Open Banking

Successful API calls

This chart shows the number of successful API calls made by third party providers using account providers' (ASPSPs)* Open Banking APIs.



Notes on the data: Successful API calls are based on data submitted by account providers (ASPSPs) to Open Banking. May-July 2018 includes data from 8 providers. August 2018 onwards includes data from 9 providers and 16 brands in total. In June 2019, the number of brands increased to 17. Since July 2019 we have 18 brands.

The FCA's Call for Input on Open Finance

- Published in December 2019
- FCA supportive of using the principles of Open Banking and opening access to account data across financial services and utilities
- FCA wants to be at the forefront of developments globally
- Under Open Finance a TPP could:
 - Collect a customer's financial data to present it to them or to a third party ("read" access)
 - Undertake or initiate transactions on the customer's behalf ("write" access)
- FCA is supportive of an open API model

What information could be accessed and shared?

Market	Data Shared
Savings	<ul style="list-style-type: none"> • Product information (features, terms including fees or charges) • Balance and transaction information
Mortgages	<ul style="list-style-type: none"> • Product information (features, terms including fees or charges) • Balance (size of the loan) and property value • Payment history
Consumer Credit	<ul style="list-style-type: none"> • Product information (features, terms including fees or charges) • Credit amounts, limits, and balances • Payment and usage history
Investments	<ul style="list-style-type: none"> • Product information (features, terms including fees or charges) • Balance and transaction information • Investment history and historical risk exposure
Pensions	<ul style="list-style-type: none"> • Product information • Fund value and projection • Contribution history • Fees and charges for invested assets • Current contribution rate • Drawdown rate in decumulation
Insurance	<ul style="list-style-type: none"> • Product information (policy features, terms including fees or charges, exclusions) • Basic customer data (name, address, claims history data) • Additional customer information

Potential legal and regulatory issues

- Will TPPs be regulated under Open Finance?
- What would the requirements on incumbent financial institutions involve?
- Will Open Finance allow a commercial relationship between incumbent financial institutions and TPPs?
- How will Open Finance interact with the product governance requirements?
- Who will be responsible if things go wrong?

FCA's draft "Open Finance Principles"

Draft Principle		Explanation
Principle 1	User right to share data	Consumers and businesses have a right to control and access the financial data created in respect of them in real time and grant others access
Principle 2	User right to instruct TPP	Account providers should enable TPPs to perform equivalent action to that available to consumers and businesses digitally
Principle 3	User right to control their data and share data securely	Consumers and businesses must be in control of their data. Consumers should be clear who they are giving consent to for accessing their data and for what purpose.
Principle 4	Cohesion across open finance	Development of API standards is done in a way that promotes interoperability, efficiency and usability for all users
Principle 5	Common provision of a minimum set of standardised data and transactions via open standard APIs	Providers should develop common and open standards to facilitate the sharing of a core set of data and enabling a core set of transactions
Principle 6	TPP right of access	TPPs have a right to access data and execute actions on the customer's behalf with that customer's explicit consent (on an objective, non-discriminatory and proportionate basis)
Principle 7	Accessibility of Key product information	Financial services firms should make standardised comparison information available alongside users' financial data. For example, to allow TPPs to compare products and to facilitate guidance or advice

Next steps

- FCA's Call for Input open until 17 March 2020
- FCA will work closely with the Government
- FCA expects to publish a Policy Statement in summer 2020

The background of the slide is a blue-tinted financial chart. It features a grid of dashed lines and a solid blue line that fluctuates across the chart, representing market data. The chart is partially obscured by a dark grey horizontal bar at the bottom.

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ESMA's consultation papers on MiFIR pre-trade
transparency for equities and systematic internalisers
active in non-equity instruments

Carl Fernandes

Background

- ESMA is obliged under MiFIR to report to Parliament and Council on the functioning of the transparency regime in July 2020
- CP published last week focusing on the equities regime; responses due by 17 March 2020
- A second CP focusing on the non-equities regime is due in the next few weeks
- A third CP was also published last week, focusing on the non-equities SI regime (a separate ESMA mandate); responses due by 18 March 2020
- Looks like MiFID 3 will be “death by a thousand cuts” . . .

Equities transparency: ESMA's observations

- Lots of detailed technical analysis – statistician's dream
- There are differences in trends between asset classes (e.g. shares, ETFs, other equity-like instruments)
- No significant change in trading volume on venue; still significant portion with SIs and OTC
- Still significant reliance on transparency waivers; increased shift to LIS waiver
- Proposals to simplify and improve transparency; some proposals may conflict

Equities transparency: ESMA's proposals (1)

- **Trading Venues**

- Waivers generally: The pre-trade transparency waivers are being overused; they should be “the exception and not the norm”
- RP & NT waivers: ESMA suggests removing them for liquid and illiquid instruments (but not the waiver for negotiated trades subject to conditions other than the current market price)
- DVC: Linked to the above, ESMA proposes eliminating the trading venue level cap and either maintaining or reducing the EU level cap; and subjecting illiquid instruments to the DVC
- Liquid instruments: ESMA proposes amending the definition of liquid market to more accurately capture instruments that should be considered liquid, e.g. by looking at trades occurring over a set period of days as opposed to daily
- Frequent Batch Auction systems: ESMA notes that these systems should be considered as separate from conventional auction systems, subject to pre- and post-trade transparency requirements

Equities transparency: ESMA's proposals (2)

- **MSTO**

- Brexit: ESMA acknowledges that its current proposal (which looks at whether an instrument has an EU or non-EU ISIN) is not sufficient and suggests also looking at whether an issuer has actively sought to have its shares admitted to trading on a non-EU trading venue
- SIs: ESMA is considering whether SIs should remain an eligible execution venue under the MSTO
- Exemptions: ESMA is considering whether the exemptions should be maintained; in particular, the differing interpretations of what amounts to a “non-systematic, ad-hoc, irregular and infrequent” transaction are problematic

Equities transparency: ESMA's proposals (3)

- **Systematic Internalisers**

- Minimum quoting size: ESMA proposes increasing the minimum quoting size to 50% or 100% of SMS
- Illiquid instruments: ESMA proposes extending the transparency obligations to illiquid instruments thereby better aligning the pre-trade transparency SI regime with that for trading venues

- **Post-trade Transparency**

- Assessment: ESMA is satisfied with the levels of post-trade transparency being provided by trading venues and SIs
- MSTO: ESMA proposes introducing a new post-trade transparency indicator which would flag when a transaction is not subject to the MSTO but subject to post-trade transparency

FICC SI regime: ESMA's observations

- Firm quotes: ESMA notes that the interpretation currently adopted by some firms could render pre-trade transparency meaningless because it is, in effect, provided at the same time as post-trade transparency
- Commercial policy: ESMA notes that there are a range of factors being used to deny access to SI quotes and is looking to determine the impact on SI clients
- Illiquid non-equities: The current illiquid instruments regime is rendered meaningless by Article 18(2); ESMA queries whether the regime should be simplified or abolished altogether
- Trading venues: ESMA seeks to establish whether there should be a level playing field between SIs and trading venues

FICC SI regime: ESMA's proposals

- Access: SIs should only be required to trade on the published quote with the requesting client and should have discretion to trade with other clients
- Exceptional market circumstances: ESMA suggests aligning with Article 3 of RTS 8 (on market making schemes), which allows withdrawal of liquidity if: (i) technological issues; (ii) risk management issues; and (iii) the inability to hedge due to a short selling ban
- Details to be made transparent: Develop RTS to ensure that the data to be made public is harmonised across firms, by introducing symbols and a list of details (as it has done in respect of post-trade transparency)
- Publication arrangements: ESMA suggests that the RTS should specify the requirements to be met by SIs for publishing their quotes and that, as set out in Q&A, the arrangements should align with the equities regime

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