

REGULATORY DEVELOPMENTS IN Q4 2010

A TRAINING AND COMPETENCE PAPER

January 2011

CONSULTATION PAPERS

10/22 6 October Quarterly Consultation No. 26

A 213 page document summarising various amendments to certain sections of the Handbook, including SYSC 20 (reverse stress-testing a firm's business plan; that is, it must carry out stress tests and scenario analyses that test its business plan to failure).

Other amendments include changes to credit and counterparty risk reporting and an increase in the deposit protection scheme limit from £50,000 to £85,000 to comply with the €100,000 requirement of the Deposit Guarantee Schemes Directive.

10/23 14 October Decision Procedure and Penalties manual and Enforcement Guide review 2010

A 46 page document outlining up-to-date statements of FSA's approach to enforcement including a new rule in GEN that an authorised firm must not pay a financial penalty imposed on a present or former employee, director or partner of the firm or an affiliated company. The amendments also prevent a recipient of a decision notice from publishing the notice or any details concerning it unless FSA have published the notice or those details.

10/24 26 October Regulatory fees and levies - policy proposals for 2011/12

A 115 page document proposing technical, mostly minor, changes to the fees charged to authorised firms. It proposes to charge electronic money issuers up to £15,750 annually depending on the amount of outstanding liabilities. Also a change is proposed to the way transaction reporting charges are levied under individual contractual arrangements where firms report as clients of the FSA's Transaction Reporting System (TRS). Of note is that the number of transactions reported daily has risen from 2 million in 2007 to up to 14 million at present. FSA expect this volume to increase further as the market continues to develop – including reporting Alternative Instrument Identifier (Aii) transactions.

FSA also confirm that fund managers in fee-block A.7 should exclude their own funds when calculating the total value of assets under their management as the tariff base for fees.

CP10/25 29 October Implementation of the second Electronic Money Directive: supplement to HM Treasury's consultation

Since 2002, FSA has regulated the issuance of electronic money by credit institutions, authorised electronic money institutions and small electronic money issuers. The second Electronic Money Directive is a new European Union directive that requires member states to make adjustments to how electronic money is regulated.

This 127 page document proposes changes to the Handbook that can be summarised as follows:

- Changes to the Perimeter Guidance manual (PERG) to help businesses consider whether they fall within the scope of the draft Regulations.
- Changes to the ombudsman service's jurisdiction so it can perform an out-of-court redress function for issuing and redeeming electronic money within the second Electronic Money Directive's scope, and consequent changes in the scope of the complaints handling rules.
- Proposals about reporting requirements. It also includes a change for payment services providers.
- Changes to the Enforcement Guide.
- Some consequential changes to the Handbook.

CP 10/26 9 November Pension reform - Conduct of business changes

A 42 page consultation on how FSA proposes to bring its conduct of business rules in line with the DWP's new rules under the Pensions Act 2008 which becomes effective in October 2012.

Employers will be required to automatically enrol their eligible employees into a qualifying pension and contribute into it. Employers may choose the type of scheme they wish to use, including the National Employment Savings Trust (NEST), a multi-employer occupational pension scheme.

FSA is proposing changes to the Conduct of Business sourcebook to ensure consumers remain protected and that there are no unnecessary barriers to employers using group personal pensions for automatic enrolment, for instance by disapplying the Distance Marketing Directive to automatic enrolment.

CP 10/27 10 November Implementing CRD3 requirements on the disclosure of remuneration

(51 pages) Effective 1 January 2011, credit institutions and "CAD Investment Firms" have to disclose, at least annually, the following:

- a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;
- b) information on link between pay and performance;
- c) the most important design characteristics of the remuneration system, including, information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;
- d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;
- e) the main parameters and rationale for any variable component scheme and any other non-cash benefits;
- f) aggregate quantitative information on remuneration, broken down by business area;

g) aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution, indicating the following;

i) amounts of remuneration for the financial year, split into fixed and variable remuneration, and number of beneficiaries;

ii) amounts and form of variable remuneration, split into cash, shares and share-linked instruments and other;

iii) amounts of outstanding deferred remuneration, split into vested and unvested portions;

iv) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;

v) new sign-on and severance payments made during the financial year, and number of beneficiaries of such payments; and

vi) the amounts of severance payments awarded during the financial year, number of beneficiaries, and highest such award to a single person.'

In the case of directors of credit institutions that are significant in terms of their size, internal organisation and the nature, scope and the complexity of their activities, the quantitative information referred to in this point shall be made available to the public at the level of directors within the meaning of Article 11 of the Capital Requirements Directive.

CP 10/28 16 November Mortgage Market Review: Distribution & Disclosure

The focus of FSA's proposals for regulatory reform so far has largely been on the lender. This 98 page CP turns to the mortgage sales process and the role of the seller (both intermediary and branch-based).

FSA are proposing changes to the Mortgages and Home Finance: Conduct of Business sourcebook (MCOBs) to ensure that every mortgage sold is assessed against the customer's needs and circumstances, and disclosure focuses on key pieces of information being given early on in the process.

CP 10/29 17 November Platforms: Delivering the RDR

Proposals to ensure that the platform services used to buy and manage investments after January 2013 are fully aligned with standards required by the Retail Distribution Review.

The proposals (87 pages) aim to prevent product providers from making payments that advisers could use to disguise the charge the customer is paying for advice, and which could influence advisers in recommending one product over another. Allowing such payments could undermine what FSA have set out to achieve for consumers by removing commission bias and could in their view leave product charges at an artificially high level. The proposals also:

- Ensure platforms allow their customers to transfer their investments elsewhere without having to cash them in first – a practice which can result in losses;

- Require platforms to be upfront about the income they receive from fund managers or product providers to make it easier for advisers and consumers to compare different types of platform and the services provided;
- Make sure that customers who invest in funds through platforms are provided with information about the fund from their fund managers, and maintain their voting rights.

Total consultation pages Q4 2010 - 681

DISCUSSION PAPERS

There were no Discussion Papers in the quarter.

POLICY STATEMENTS

PS10/16 20 October

Client Assets Sourcebook (Enhancements) Instrument 2010 Feedback on CP10/9 and made rules

Further CASS rules and policies to enhance the protections offered by CASS in response to issues highlighted by the global financial crisis and a number of insolvency appointments – most notably that relating to the insolvency of Lehman Brothers.

Annex B part 1 provides amended text for the CASS sourcebook that comes into force 1 January 2011:

Firm types. Firms that hold client money or customer assets will be classified as “CASS firm types” – large (over £1 billion of client money or £100 billion of safe custody assets; medium (over £1 million of client money or £10 million of safe custody assets; and small (less than £1 million of client money or £10 million of safe custody assets).

Reporting to FSA. CASS firms must notify FSA by 31 January 2011 what type they are and the highest total value of client money and custody assets held in the calendar year 2010. The time limit for subsequent periodic notifications (CMARs) reduces to 15 days. From 1 June 2011 reporting must be monthly for medium and large CASS firms and six-monthly for small CASS firms, including nil returns where relevant. A pro forma is provided at SUP 16 Annex 29R.

Operational oversight. Firms have to allocate to a senior manager or director (normally the compliance officer) who must be approved for the purpose, responsibility for:

- 1) oversight of the firm’s operational compliance with CASS;
- 2) reporting to the firm’s governing body in respect of that oversight; and
- 3) completing and submitting a CMAR to the FSA.

Record keeping. CASS firms must record who is the CASS officer and what size of CASS firm they are. Also they must record the highest total amount of client money and custody assets for each year

Annex B part 2 contains special rules for prime brokerage firms, effective 1 March 2011, including:

- 1) Requirement to have written agreements in place with their subcustodians that does not allow the subcustodian to grant a lien over the relevant assets. Brokers must keep copies of the agreements;
- 2) The agreement must contain a disclosure annex specifying such things as contractual limits on custody assets the broker is permitted to use and a risk warning;
- 3) Daily reporting to clients of certain specified line items such as cash, margin and short sale obligations.

Annex B part 3, effective 1 June 2011, limits to 20% of total client money the amount that can be held with related group companies. Note that Lehmans had around 50% of its client money in Lehmans group accounts. Firms must report to FSA the identities of depositories and the amounts deposited with them to enable FSA to monitor compliance with this limit.

PS10/17 11 November

Taping of mobile phones - Feedback on CP10/7 and final rules

COBS 11.8 (Recording telephone conversations and electronic communications) is amended so that firms “ must take reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the firm is unable to record or copy”. Effective 14 November 2011.

PS10/18 17 December

Feedback to CP10/12 Competence and ethics and final rules

Effective 1 January 2011.

The T&C module is moving from the Business Standards block of the Handbook to the High Level Standards block. Also the word “training” has been dropped from the SYSC rules.

APER principles are amended to prohibit individuals from deliberately not paying due regard to the interests of a customer and deliberate acts, omissions or business practices that could be reasonably expected to cause consumer detriment. APER Principal 5 states that approved persons should take reasonable steps to satisfy themselves, on reasonable grounds, that each area of the business for which they are responsible has in place appropriate policies and procedures for reviewing the competence, knowledge, skills and performance of each individual member of staff.

In a lengthy annex FSA provides a list of “appropriate qualifications” and accredited providers such as trade bodies , universities and stock exchanges, both in the UK and abroad.

The exam requirements apply to any individual who deals, advises or manages investments or who oversees on a day-to-day basis administration, client money, custody or collective investment schemes – both trustee/custodian and operator.

The requirements apply only to activities carried on for retail customers. Individuals have 30 months in which to pass the exam after starting the activities.

PS10/19 17 December

Strengthening Capital Standards 3 - Feedback and final rules for CP10/17 (chapters 11-13) and CP10/22 (chapter 3)

These rules implement CRD2 and CRD3 and are effective from 31 December 2010.

GENPRU and BIPRU are amended in certain highly technical aspects which apply to firms subject to the Capital Requirements Directive, particularly in relation to:

Core tier one capital – core tier one instruments for joint-stock companies are restricted to ordinary shares, preferential right to a dividend not permitted and exceptions for mutuals.

Operational risk – haircuts for uncertainty of insurance coverage and specific conditions for the use of Other Risk Transfer Mechanisms (ORTM).

Large exposures – Applying CEBS guidelines, securities settlement, losses from schemes with underlying assets and economic interconnectedness.

PS10/20 17 December

Revising the Remuneration Code - Feedback on Feedback on CP10/19 and final rules

The intention of these rules, effective 1 January 2011, is to sustain market confidence and promote financial stability through reducing the incentives for inappropriate risk-taking by firms, and thereby to protect consumers. The new rule (SYSC 19A) applies to BIPRU firms for remuneration paid after 1 January 2011, including remuneration awarded, but not yet paid, before 1 January 2011, for services provided in 2010.

The Code applies to “Remuneration Code staff”, which comprises categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on a firm's risk profile.

There are 12 principles-based rules, of which no. 12 is subdivided into 8 sections, therefore 19 in total. These are summarised as follows:

- 1 Remuneration policy must be consistent with and promote sound and effective risk management and not encourage risk-taking that exceeds the level of tolerated risk of the firm.
- 2 Remuneration policy must be in line with the business strategy, objectives, values and long-term interests of the firm.
- 3 Remuneration policy must include measures to avoid conflicts of interest.
- 4 Governance. A firm’s governing body must adopt and periodically review the general principles of the remuneration policy and is responsible for its implementation. Larger/more complex firms must establish a remuneration committee that must be independent of executive functions of the firm and set standards and policies that take into account the long-term interests of shareholders, investors and other stakeholders in the firm.
- 5 Control functions (such as Compliance and Internal Audit). Firms must ensure that employees engaged in control functions:

- (1) are independent from the business units they oversee;
- (2) have appropriate authority; and
- (3) are remunerated:
 - (a) adequately to attract qualified and experienced staff; and
 - (b) in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.

Firms must ensure that the remuneration of the senior officers in risk management and compliance functions is directly overseen by the remuneration committee, or, if such a committee has not been established, by the governing body in its supervisory function.

6 A firm must ensure that total variable remuneration does not limit the firm's ability to strengthen its capital base.

7 Where the government has intervened (eg. RBS, Lloyds TSB) bonuses should only be paid when justifiable. FSA expect a ban on paying bonuses to senior personnel of firms that benefit from exceptional government intervention to apply to senior personnel who were in office at the time that the intervention was required.

8 Profit-based remuneration has to take into account all types of current and future risks.

9 Pre-retirement age pension payments are subject to a five year retention period.

10 Employees must undertake not to use personal hedging strategies or remuneration- or liability-related contracts of insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

11 Bonuses must not be paid through vehicles or methods that facilitate avoidance of the Remuneration Code.

12 Structures. Principle 12 goes into much detail about amounts and limits on fixed, guaranteed and variable remuneration, percentages to be paid in shares and deferral periods.

The Code also features 20 pages of guidance on how to apply it “proportionately”.

PS10/21 17 December

Implementing CRD requirements on the disclosure of remuneration - feedback on CP10/27 and final rules

This new section, consisting of BIPRU 11.5.8 to 11.5.21, becomes effective 1 January 2011 under the Pillar 3 regime. The text of the rules is reproduced here:

“Disclosures: remuneration

BIPRU 11.5.18  01/01/2011

A firm must disclose the following information, including regular, at least annual, updates, regarding its remuneration policy and practices for those categories of staff whose professional activities have a material impact on its risk profile:

- (1) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;*
- (2) information on the link between pay and performance;*
- (3) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;*
- (4) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;*
- (5) the main parameters and rationale for any variable component scheme and any other non-cash benefits;*
- (6) aggregate quantitative information on remuneration, broken down by business area;*
- (7) aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the firm, indicating the following:*
 - (a) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;*
 - (b) the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;*
 - (c) the amounts of outstanding deferred remuneration, split into vested and unvested portions;*
 - (d) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;*
 - (e) new sign-on and severance payments made during the financial year, and the number of beneficiaries of those payments;*
 - (f) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.*

[Note: Paragraph 15 of Annex XII to the Banking Consolidation Directive.]

BIPRU 11.5.19  01/01/2011

The FSA would normally consider the requirements to publish disclosures in accordance with BIPRU 11.3.8 R and 11.3.9 R in respect of BIPRU 11.5 as a whole to meet the requirement in paragraph 15 of Annex XII to the Banking Consolidation Directive to publish "regular, at least annual, updates" (as implemented in BIPRU 11.5.18 R).


BIPRU 11.5.20  01/01/2011

(1) A firm that is significant in terms of its size, internal organisation and the nature, scope and the complexity of its activities must also disclose the quantitative information referred to in BIPRU 11.5.18 R at the level of senior personnel.

(2) Firms must comply with the requirements set out in BIPRU 11.5.18 R in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to the UK or other national transposition of Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

[Note: Paragraph 15 of Annex XII to the Banking Consolidation Directive.]

[Note: The FSA has given guidance for the purpose of providing a framework for complying with the disclosure requirements of BIPRU 11.5.18 R in accordance with the proportionality test set out in BIPRU 11.5.20 R (2). The guidance divides firms into four tiers, and indicates which requirements should be complied with for each tier. It was published in Policy Statement 10/21 'Implementing CRD requirements on the disclosure of remuneration: Feedback on CP10/27 and final rules' and is available at <http://www.fsa.gov.uk/Pages/Library/Policy/Policy/index.shtml>.

BIPRU 11.5.21  01/01/2011

In the FSA's view, the exemptions from disclosure provided for in BIPRU 11.3.5 R (materiality) and BIPRU 11.3.6 R (proprietary or confidential information) are unlikely to apply to the disclosure required by BIPRU 11.5.18 R (having regard, amongst other things, to the fact that the requirements set out in BIPRU 11.5.18 R are to be complied with in the manner described in BIPRU 11.5.20 R (2))."

Note: FSA published 390 pages of rules on 17 December 2010 which all became effective 1 January 2011 – just two weeks! Is the message that Compliance Departments were expected to cancel their holiday arrangements? What timing!

FSA DISCIPLINARY ACTIONS - FINES

FSA fines – 1 October to 31 December 2010 – in £1000s

27/09/2010	Fabio de Biase	252.24
12/10/2010	Mark Bates	264.70
12/10/2010	Alan Hill	150.00
20/10/2010	Andre Jean Scerri	66.00
04/11/2010	Bridging Loans	42.00
04/11/2010	Joseph Cummings	70.00
13/12/2010	Paolo Maranza	105.00
13/12/2010	Laurence Finger	35.00
13/12/2010	Sedley Voulters	163.14
13/12/2010	Nabeel Naqui	750.00
13/12/2010	Perry Bliss	30.00
14/12/2010	William Coppin	70.00
16/12/2010	Scottish Equitable	2,800.00
Total fines for Q4		<u>4,545.84</u>

Fines 1 April to 30 September 2010 79,978.54

Fines for nine months to 31 December 84,524.38

Of note is the monetary amount which for the first three quarters of FSA's financial year amounts to more than five times the total annual average for the prior three years. This is a tenfold increase and represents 18.59% of FSA's total budget for the year (25% annualised). At this rate regulated firms can expect a 25% discount on next year's authorisation fees.