PART

One

Commentary and Context

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CHAPTER 1

The UK Regulatory Environment

Although many of the concepts and practices described in this text are products of a growing Compliance discipline that does not proceed directly from any regulatory rule or guidance, regulation is undoubtedly the founding spark and ultimate justification of all Compliance activity in the financial services industry. It is almost certainly true that there would be no Compliance function, Compliance Officers or Compliance anything else if there had not first been a regulatory system in which to put them. It therefore follows that, to get to grips with Compliance, one should have a sound understanding of the regulatory environment that gave rise to it.

This is not to say that Compliance does not justify itself on its own terms, but few financial services businesses volunteer for it; few want to be 'fettered' by a framework of 'restrictions'. Certain firms that are on the perimeter of needing to be regulated have chosen to employ Compliance Officers. Furthermore, a number of firms in industries such as healthcare, pharmaceuticals, beverages and even auction houses have chosen to employ Compliance Officers. However, financial services regulations are there because the industry has purposes to serve beyond the enrichment of those it employs directly, but has a patchy record when it comes to making itself fit for the pursuit of any other ends. Compliance is there because it is too risky and too complicated to try to navigate the regulatory terrain without it.

Therefore, while I dedicate this text to making arguments for the positives that a business can take from effective Compliance, there is no question that it began and, to a large degree, remains an agent of regulation and can only be properly understood with the regulatory regime, in the UK as elsewhere, as a starting point.

Before looking in detail at the constituent parts of the Compliance Officer's world, this chapter fills in the essential background with a brief description of the regulatory environment in the UK. Compliance Officers working in other jurisdictions should know at least as much about their own regulatory environment as that described here for the United Kingdom.

1.1 REGULATION IN THE UK

There is currently a myth in the UK that we have just two financial regulators (the PRA and the FCA) and a single piece of regulatory legislation (the Financial Services and Markets Act 2000 (FSMA) as amended). If you have bought into this story, then you need to think again. In the UK alone there are numerous regulatory bodies other than the PRA and FCA that cover financial services activities – the Pensions Regulator, for example, and the Takeover Panel. There are also a

number of laws and regulatory-type bodies that govern the national anti-money laundering effort. And, looking further afield, it's impossible to deny that overseas legislation and regulators affect financial services activity carried on within your chosen jurisdiction. The UK Bribery Act and FATCA are two very good examples of statutes with significant, extraterritorial application. (See Box 6, 'Going Global' on page 345 for further explanation on this point.)

Most, but it must be stressed *not* all, of the UK regulatory framework is based on UK and EU law.

FINANCIAL SERVICES LEGISLATION IN THE UK

UK Law

- UK law can be divided into two main types:
  - statute law – law created through acts of parliament.
  - case law or common law – law established through legal precedent developed over hundreds of years from custom, tradition and cases coming to court.
- Statute law is of most relevance to financial services although common law also has an impact through, for example, contract law in relation to loan agreements.
- A piece of statute law cannot become final until it has been agreed by both Houses of Parliament and has subsequently received Royal Assent from the Queen.
- Acts of Parliament cannot possibly contain every single detail relating to the area they govern. Consequently, secondary or delegated legislation is used to update and amend statute law without having to go through the full legislative process. This secondary legislation, referred to as *statutory instruments* or *regulations*, has the full force of law.

The EU Dimension

- As the UK is a member of the European Union, the UK government must implement EU legislation.
- The main way in which EU law has historically had an impact on UK regulation is through the implementation of the directives and regulations issued as part of the EU's Financial Services Action Plan (see Box 5 on page 343) and the Lamfalussy Process. However, EU regulation is frequently updated, such that numerous directives have been updated multiple times. CRD IV is a good example of this in the area of capital adequacy standards for financial institutions.
- Directives and regulations are pieces of EU legislation that are binding on its member states[1] and on non-member states within the European Economic Area (EEA).[2] Directives allow national governments certain flexibility in terms of how the end result is achieved and need to be transposed into the law of each member

[1]At the time of writing there are 28 EU member states: Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.

[2]At the time of writing these are Norway, Iceland and Liechtenstein.

state whereas regulations do not require such transposition and thus apply directly to individual member states without being separately implemented in each country.
- EU law is aimed at harmonizing standards across the EEA in order to support the single market objective and the relevant directives and regulations apply across the EEA in the same way that they apply to the UK, although the extent to which they have really been implemented in letter and spirit across each member state has often been a matter of debate.

Overseas Legislation

- Some pieces of legislation enacted in other jurisdictions are applied on an extra-territorial basis.
- For the financial services industry, the main pieces of relevant legislation falling into this category come from the USA.

Sitting underneath and alongside the legislation are the requirements that stem from sets of rules, guidelines and industry best practice that underpin the law.

1.2 DIFFERENT REGULATORY REGIMES IN THE UK

It is possible to group pieces of legislation, sets of requirements, etc., together into various subject areas and thus the UK regulatory framework can be divided into various distinct areas (although there is a certain degree of overlap). These include:

- the FSMA regime for investment business;
- the anti-money laundering regime; and
- the takeover regime.

The key features of these are described below.

1.3 THE FSMA REGIME FOR INVESTMENT BUSINESS

The Financial Services and Markets Act 2000 (FSMA) came into effect on 30 November 2001, a date also referred to as N2. Under FSMA, the FSA was established as the UK's regulator for a large proportion of financial services activity (see below), replacing the nine existing regulators that were previously responsible for supervising the UK's financial markets. The Financial Services Act 2012 effected a further change in the UK regulatory structure. On 1 April 2013, the FSA was replaced by two new regulators – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The PRA is responsible for the prudential regulation of all banks, plus major insurance firms and investment firms. The FCA is responsible for conduct, market integrity, financial crime and competition issues for all firms, along with the prudential regulation of those firms not prudentially regulated by the PRA.

WHAT DO THE PRA AND FCA REGULATE?

FSMA requirements apply to 'specified activities' that are undertaken in relation to 'specified investments' (as defined by the Regulated Activities Order (RAO)) made under FSMA.

Examples of Specified Activities

- Dealing
- Managing investments
- Safeguarding and administering investments
- Establishing a collective investment scheme.

Examples of Specified Investments

- Shares
- Bonds
- Futures
- Options
- Contracts for differences
- Units in collective investment schemes.

The terms 'investment business' or 'regulated business' are commonly used to refer to the carrying out of specified activities in relation to specified investments.

Examples of Activities and Financial Instruments not Specified by Statute

- Cash
- Premium bonds
- Spot FX
- Commodity derivative transactions undertaken for commercial rather than investment purposes
- Letters of credit
- Bills of exchange
- Promissory notes.

There is a further distinction between designated and non-designated investment business (see table on page 9).

Of course the above is summary information only. Full information is available in the RAO, which is an extremely useful document when determining what is and is not subject to PRA and FCA rules.

The break-up of the FSA, which occurred on 1 April 2013, but which had been the subject of major preparation for well over a year before that date, came as a result of the view that the single regulator did not perform adequately prior to the financial crisis of 2008. The FSA was heavily criticized for its handling of Northern Rock, a medium-sized provincial bank, which had to be rescued.

The FSA's own review, carried out by Rosemary Hilary, head of FSA's Internal Audit team, showed four key failings in the FSA's regulatory approach to Northern Rock:

- A lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions.
- A lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision.
- Inadequate specific resource directly supervising the firm.
- A lack of intensity by the FSA in ensuring that all available risk information was properly utilized to inform its supervisory actions.[3]

The creation of two regulators was based on the theory that it is difficult for one regulator to concentrate simultaneously on strategic, financial stability issues as well as concerns around the conduct of firms both in the markets and vis-à-vis its customers.

The PRA and FCA are responsible to the Treasury. The FCA must also account to a consumer panel and a practitioner panel on the extent to which it is meeting the regulatory objectives that have been set out for it. Both regulators have translated requirements from UK and various EU laws into a comprehensive handbook of rules and guidance covering a wide range of topics including:

- conduct of business;
- enforcement;
- collective investment;
- financial resources; and
- senior management controls.

Both FSMA and the PRA and FCA *Handbooks* must be amended on an ongoing basis to take account of new requirements stemming from EU law. The key EU legislative initiatives that are of relevance to financial services are the Financial Services Action Plan (see Box 5 on page 343) and the Lamfalussy Process. The pieces of EU legislation that have had the greatest impact on the UK regulators' *Handbooks* are probably the Markets in Financial Instruments Directive (MiFID) (see Box 9 on page 350), the Market Abuse Directive and the various iterations of the Capital Requirements Directive. Where MiFID is concerned, it is unfortunate that its scope does not entirely tally with that of FSMA and gives rise to a situation in which different rules apply, dependent on whether an activity is regulated only under FSMA, or is also covered by MiFID. The table on page 9 gives further details on this.

[3] FSA Press Release FSA/PN/028/2008, 26 March 2008.

Some of the other key elements of the UK regime are described below:

- The regulators must comply with the statutory objectives imposed on them.
- It is an offence to conduct a regulated activity in the UK unless you are authorized under FSMA or exempt from its requirements. This is known as 'the General Prohibition'.
- There are various ways of gaining authorization:
  - obtaining permission to carry out regulated activities under part IV of FSMA;
  - exercising passporting rights under a relevant EU directive (EEA Passport rights); or
  - exercising rights under the Treaty of Rome (Treaty rights).
- There are various categories of person subject to regulation:
  - regulated firms;
  - individuals working for regulated firms;
  - recognized professional bodies;
  - exchanges and clearing houses; and
  - collective investment schemes.
- Although FSMA requirements have been translated into the PRA's and FCA's *Handbooks*, the two regulators are increasingly adopting a much more principles-based approach to regulation. Opinion remains undecided in the industry as to whether this is a good thing or not – see Box 1 on page 335 ('Acting on Principle').
- Although all business specified in the RAO is subject to FSA regulation, the PRA and FCA have further 'designated' certain types of investments and investment business to which it applies particular sets of rules, such as those in the Training and Competence and Conduct of Business Sourcebooks. Further detail is available in the table on page 9.
- The FCA is the competent authority for UK stock exchange listings.
- The FCA does not directly regulate takeovers and mergers, although it does endorse the Takeover Code and imposes a number of requirements that are relevant in such situations.

The UK regulators are often heavily criticized both by the Compliance fraternity and by our colleagues in other areas of finance, but much as it can be cathartic after a long day in the office to denigrate the regulators, there is also much to be said for giving credit where credit is due. Compared with a number of comparable overseas regulatory bodies, believe me, the UK regulators are not that bad. Some of their plus points are that they:

- have a transparent and active enforcement process;
- consult widely on new requirements and take account of the responses to these consultations when formulating new regulations;
- provide substantial guidance on its rules;
- maintain a comprehensive website for regulated firms;
- offer important consumer guidance in the form of brochures and leaflets, as well as via the dedicated sections of its website;
- have clear statutory and regulatory objectives, which provide a valuable yardstick for assessing their performance and setting their priorities;
- cooperate with many other regulators in the UK and internationally, and do their best to protect us from the worst excesses of the EU regulatory machine;
- do not change their rules on a whim, and on an almost daily basis, as some regulators are wont to do;

- are manifestly accountable in their activities through a number of mechanisms including:
  - the office of fair trading (which can scrutinize PRA and FCA rules and practices);
  - the Financial Services and Markets Tribunal;
  - the Consumer Panel;
  - the Practitioner Panel; and
  - the Complaints Commissioner.

That said, at the time of writing, the PRA and FCA are imposing a level of regulatory scrutiny, which is unheard of in UK financial services. The boards of major financial institutions are spending an increasing amount of time approving their firms' approach to the implementation of key regulatory initiatives and less time actually running the business. London continues to be one of the world's most important financial centres with no prospect on the horizon of that changing. It would seem churlish to refuse the UK regulators at least some small part of the credit for establishing and maintaining a regulatory environment in which firms are happy to do business. However, whether the UK's position in the world's leading financial centres continues – and whether this is because of or in spite of increased regulatory scrutiny – remains to be seen.

Types of business under FSMA/MiFID

Type	Source	Explanation
Investment services and activities	The PRA, FCA and MiFID	Services relating to financial instruments, including: ■ executing client orders; ■ operating an MTF; ■ portfolio management; ■ dealing on own account; ■ making a personal recommendation.
Financial instrument	The PRA, FCA and MiFID	■ Transferable securities, e.g. shares and bonds. ■ Money market instruments, e.g. Treasury bills, certificates of deposit and commercial paper. ■ Units in collective investment undertakings. ■ Futures, options, swaps and forward rate agreements on a number of instruments including: ■ securities; ■ currencies; ■ interest rates; ■ financial indices; ■ commodities that can be physically settled as long as they are traded on a regulated market and/or an MTF; ■ climatic variables; ■ freight rates; ■ telecommunications bandwidth.
Specified investment	RAO	Specified investments are those that have been listed as such in Part III of RAO, and to which FSMA requirements apply.
Specified activity	RAO	Specified activities are those that have been listed as such in Part II of RAO, and to which FSMA requirements apply.

(*continued*)

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Type	Source	Explanation
Designated investment	The PRA and FCA	■ Designated investments are a subset of specified investments to which detailed PRA and FSA requirements apply, such as those in COBS and TC. ■ Examples of investments 'specified' under RAO but not 'designated' by the PRA and FCA include Lloyd's syndicate membership, rights under a funeral plan contract, deposits and electronic money, and certain mortgage contracts. ■ A number of designated investments are not defined as 'financial instruments' under MiFID.
Designated investment business	The PRA and FCA	■ Includes the following, where they are carried on by way of business: ■ dealing in investments as principal; ■ dealing in investments as agent; ■ arranging deals in designated investments; ■ managing designated investments; ■ operating an MTF; ■ safeguarding and administering designated investments; ■ safeguarding and administering designated investments; ■ establishing, operating or winding up a collective investment scheme; ■ providing advice on designated investments; ■ Certain PRA and FCA rules (such as those in TC) are applicable to designated investment business whereas they do not apply to other activities. ■ Examples of investment activities 'specified' under RAO but not 'designated' by the FSA include accepting deposits, advising on Lloyd's syndicate participation and mortgage lending.
MiFID business	MiFID and the PRA and FCA	Investment services and activities, and where relevant ancillary services, carried on by a MiFID investment firm.
Non-MiFID business		Designated investment business that is not within the MiFID definition of investment services and activities. Examples include: ■ Lloyd's business; ■ some investment research; ■ sports and leisure spread betting; ■ operators of collective investment schemes; provision of insurance; ■ managers of investment trusts; and ■ provision of occupational pension scheme services, such as fund management.
Ancillary services	MiFID and the PRA and FCA	Includes: ■ safekeeping and administration of financial instruments belonging to clients; ■ corporate finance advice;

(*continued*)

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Type	Source	Explanation
		■ providing margin trading services; ■ investment research; ■ underwriting services.
MiFID investment firm	MiFID and the PRA and FCA	An investment firm, or credit institution providing investment services, to which MiFID applies, and a firm providing services under Article 5(3) of UCITS.
Equivalent business of a third country investment firm	MiFID and the PRA and FCA	The business of an investment firm operating in the UK but based in a non-EEA state, which would be MiFID business if the firm were a MiFID investment firm.
Common platform firm	The PRA and FCA	A firm to which both MiFID and CRD (the Capital Requirements Directive) apply.

1.4 THE UK'S ANTI-MONEY LAUNDERING REGIME

Money laundering is the process by which criminals hide the illicit origins of their cash or other assets (see Box 13 on page 357, 'The Laundering Process') and integrate them into the legitimate financial system. The term was traditionally used in relation to the spoils of drug trafficking, but it now covers the proceeds of any sort of criminal activity, from petty crime and 'minor' tax fiddles to full-scale organized crime such as people smuggling and VAT fraud.

Another major area that comes under the banner of money laundering is terrorist financing, which takes place when terrorists use the financial markets to:

- carry on otherwise legitimate businesses of which the profits will be used to promote terrorism;
- finance bogus charities used to promote terrorist beliefs and causes;
- buy arms; and
- fund terrorist action.

Given the massive scale of the problem (some statistics are provided on page 353) how realistic is it to believe that not a single dirty dollar has ever passed through your firm? It is no wonder that one of the FCA's four statutory objectives is to reduce financial crime and that a range of other regulatory organizations also make this a priority. At the very highest level, the approach to anti-money laundering and counter-terrorist financing controls is set by the United Nations, which is behind a number of international conventions in this area, such as the 1988 Vienna Convention Against Drug Trafficking and the UN Convention for the Suppression of Terrorist Financing. The EU has also been an enthusiastic legislator against money laundering with its latest major initiative being the Fourth Money Laundering Directive. Perhaps the most influential supranational body in the area of anti-money laundering has been the Financial Action Task Force (FATF). The FATF is an intergovernmental body representing 180 jurisdictions, with the intention to establish and maintain effective legal, regulatory and

operational measures for combatting money laundering, terrorist financing and other financial crime. Based to a large extent on the above, the UK has implemented its own anti-money laundering and counter-terrorist financing legislation and, in addition, we have a copious amount of industry guidance, some of which is voluntary, such as that from the Basel Committee of Banking Supervision, and some of which has quasi-regulatory status. The most significant entry in the latter category is the JMLSG Guidance Notes. These notes provide comprehensive 'guidance' on two levels:

- The internal anti-money laundering infrastructure that financial services firms should implement (staff training, identifying and reporting suspicions of money laundering, etc.).
- The actual 'know your customer/KYC' vetting that firms should carry out in respect of particular types of customer and transaction (see Appendix B for further information).

Although the JMLSG Guidance Notes are just what they say on the box – *guidance* – you would be rather foolish to ignore them without a good reason. This is because the FCA has stated very clearly that it regards observance of the JMLSG Guidance Notes as an indicator that a firm complies with the FCA's anti-money laundering requirements, and non-observance as an indicator of the opposite.[4] You should also be aware that the anti-money laundering requirements apply much more broadly than the FSMA regime, so you must comply with requirements in this area whether or not you are undertaking investment business as defined. (Indeed, legislation also applies to a number of other sectors, including casinos, estate agents and dealers in high-value items.)

Although the JMLSG Guidance Notes are, to all intents and purposes, compulsory in the UK, they are often referred to as 'the Bible' by Compliance Officers around the world. They are regarded as best practice and are followed or consulted in jurisdictions where they are not acknowledged by the local regulators.

With the weight of this heavy legislative regime hanging over us if we get things wrong (as I write there are reports that the US Treasury is considering a $5m fine against an MLRO),[5] Compliance Officers can truly be classed as the government's unpaid foot soldiers in the fight against global crime and terrorism, leading some to complain that if they had wanted to work in law enforcement they would have chosen a different career. They argue that, given the importance of controls in this area, it is not appropriate for so much responsibility to be placed on the private sector, which has at least a short-term vested interest in not identifying any money laundering at all.

Think of the massive costs incurred by firms implementing anti-money laundering regimes of the type envisaged by today's regulations – it is similar to being charged a tax for the privilege of being able to help the government to catch criminals, and we have to question just how effective the controls we are being asked to implement really are: for instance, it is hard to believe that an international syndicate of criminals who have almost unlimited funds and resources at their disposal will allow themselves to be tripped up by not being able to produce a phone bill. Criminals can now own a number of different passports, each of which will withstand the scrutiny of immigration officials. Indeed, such is the sophistication of these organizations that they will probably employ lawyers who know the KYC rules as well as the firm itself, and will present themselves with a pristine set of KYC documents with which no fault can be found.

[4]See *The FCA Handbook* – SYSC 3.2.6E.

[5]Thomson Reuters Accelus, 17 April 2014.

Regardless of the criticisms of the regime, however, the authorities argue that it is logical for financial services firms to take the lead in identifying suspicious activity as they know their customers and their normal patterns of activity, whereas the police do not. This, admittedly, is true and it does not look like we will be relieved of our front-line duties in this area anytime soon. Indeed, one of the challenges of the Compliance Officer is to ensure that the best defence against money laundering – namely 'know your customer' – is taken seriously not just by the MLRO, but also by the client-facing people in the Front Office.

1.5 THE UK'S TAKEOVER REGIME

UK takeovers and mergers are regulated by the Panel on Takeovers and Mergers, which was established in 1968. Its key requirements are set out in the City Code on Takeovers and Mergers ('the Takeover Code'). Although the Code is not a piece of legislation, statutory weight is lent to the regime by means of:

- the Companies Act 2006, part 28;
- the EU Takeover Directive; and
- endorsement by the FCA.

Even though the Takeover Panel is entirely separate from the regulators, all three collaborate where necessary, especially in relation to market abuse, which is one of the main areas where the Panel and the FCA are likely to overlap in respect of their fields of responsibility.

Competition is another matter that must be considered at the time of a takeover or merger, and this area is governed by the Enterprise Act 2002 and a number of authorities including:

- the Competition Commission;
- the Office of Fair Trading;
- the Competition Appeal Tribunal; and
- the EU's Directorate General for Competition.

The FCA inherited a competition objective in the Financial Services Act 2012 in that it is required to promote 'effective competition in the interests of consumers in the markets for regulated financial services'.

1.6 OTHER UK REGULATORY REGIMES

In addition to the three regimes summarized above, other regulatory frameworks are in place for different aspects of the UK financial services industry, including those relating to:

- consumer credit and hire purchase, which has been moved to the FCA from April 2014;
- personal and business banking; and
- company pensions.