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STATE OF REGULATORY REFORM 2017: A SPECIAL REPORT

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Compliance officers face change, change and more change, overlaid with the challenge of an increasingly wide range of sanctions being used by regulators to drive home the need for visibly effective compliance and the resulting good customer outcomes. The uncertainty presents opportunities. Firms can seek to influence their futures rather than simply watching as rulebooks change. UK-headquartered firms will be watching the Brexit negotiations with special interest, fearful of losing passporting rights and wondering what equivalence deal may emerge, if any, once UK Prime Minister Theresa May triggers Article 50 to leave the EU, something she has said she will do by the end of March.

There are signs, however, that regulators will not be entirely defanged, and that any deregulatory wave will not be indiscriminate. Trump has kept one of Wall Street's sheriffs – the top federal prosecutor in New York – on the job. Industry veterans see little letup on enforcement against money laundering and sanctions violations. Democrats retain some power in the Senate to block legislation, and would likely try to impede any push for a full repeal of Dodd-Frank.

In Asia, those firms licensed by the Hong Kong Securities and Futures Commission (SFC) – more than 2,000 – will face a tough start to the new year, after the regulator unveiled its “manager-in-charge” regime in mid-December. It has a deadline for compliance in July and requires firms to designate certain members of senior management with responsibility for eight core functions, covering the front, middle and back office.

What regulatory developments will likely affect these world regions this year? This special report covers them all.





AMERICAS

REGULATION UNDER TRUMP: BALANCING GROWTH AND FINANCIAL RESILIENCY

To gauge where U.S. financial regulation is headed under Donald Trump's presidency, it might be helpful to use a simple maxim: If a regulation is seen as impeding the financial industry's contributions to the U.S. economy, it is a target. How one makes that determination will be the tricky part.

The reforms of the 2010 Dodd-Frank Act will be the starting point for efforts by the Republican administration and Congress to find a new balance between ensuring credit flows to underserved parts of the economy and preserving the safety and soundness of banks.

For observers across the political spectrum, there has been growing unease that the post-financial crisis objectives of a safer and more resilient financial system may have gone a step too far. By making it more costly for banks to perform their core functions, economic growth has been sacrificed to the overarching goal of financial stability. This is most observable for smaller and medium-sized firms struggling to obtain credit, many of which are no better off than they were eight years ago, and Trump's team has put their cause high on its economic agenda.

Trump's choice for U.S. Treasury secretary, former Goldman Sachs partner Steven Mnuchin, has said the primary problem with Dodd-Frank is that it is "way too complicated and it cuts back lending. So we want to strip back parts of Dodd-Frank that prevent banks from lending . . . that will be the number one priority on the regulatory side."

With that primary objective in sight, the question then becomes which parts of Dodd-Frank will be in the frame, and how they will be changed.

PEELING BACK DODD-FRANK

There are two ways in which Dodd-Frank's massive tome of regulations may be altered: by changing the rules formally – either through legislation or the regulatory rulemaking process – or by relaxing enforcement of the existing rules. Both approaches are likely in practice. In the formal approach, the prominent vehicle for considering at least a partial repeal of Dodd-Frank is the Financial CHOICE Act, a bill sponsored by Republican Rep. Jeb Hensarling, who heads the House Financial Services Committee.

The bill has a long list of changes to post-crisis regulatory reforms. They range from outright repeal of the Volcker Rule against risky self-trading by banks to curbing the Federal Reserve's independence in supervision and regulation by placing the central bank and other banking agencies under the Congressional appropriations process.



Republican Rep. Jeb Hensarling

Reuters/Joshua Roberts

The bill's provisions also include:

- Elimination of the Office of Financial Research
- Downgrading the intergovernmental Financial Stability Oversight Council and removing its authority to designate nonbank institutions, such as insurers, as systemically important financial institutions, or SIFIs
- Revising the governance and funding mechanism of the Consumer Financial Protection Bureau to give Congress more control
- Further limiting the Federal Reserve's emergency lending authority and the Treasury's authority under the Exchange Stabilization Fund
- Significantly altering the enforcement authority of the Securities and Exchange Commission (SEC)
- Repealing the Federal Deposit Insurance Corporation's systemic risk powers, including its authority to conduct anything like the Temporary Liquidity Guarantee Program
- Repealing the Orderly Liquidation Authority, as well as the Labor Department's Fiduciary Rule

It is doubtless a controversial piece of legislation, and not everything is welcomed by Wall Street.

A major plank of the CHOICE Act's sweeping changes is to provide a so-called Dodd-Frank "off-ramp" that would enable banks to win exemption from several regulatory requirements and restrictions. To do so, they would have to meet standards that would require them to raise substantially more capital and achieve elusively high ratings for overall financial condition.

Therefore, the CHOICE Act could serve more as an entry point for negotiations with Congress.

"[The CHOICE Act] has a smorgasbord of things, some of which the Republicans might move ahead on," said Annette Nazareth of the Davis Polk law firm. "It's entirely possible they could decide to choose some and add others."

A Dodd-Frank provision likely to be quickly targeted is the contentious \$50 billion asset threshold for stricter regulatory standards and supervision. The level has swept up many smaller and medium-sized banks that have complained that compliance has placed a disproportionate burden on them.

The U.S. House recently passed legislation to make the \$50 billion mark less automatic and base regulatory strictness more on the riskiness of an institution. According to House Rep. Blaine Luetkemeyer, who introduced the bill, Dodd-Frank "does not consider the fact that community banks, mid-size banks and large banks often have completely different business models, resulting in regulatory scrutiny of companies based merely on size rather than activity."

Given House approval of the bill, all eyes will be on the Senate to see whether it will come into law. Republicans retained their hold on the Senate in the November elections, but Democrats gained seats and can block or slow some legislation.

ENFORCEMENT

The degree to which enforcement is relaxed will depend largely on who will be sitting in key positions at the regulatory agencies. A critical appointment will be the vice chair of supervision at the Federal Reserve, a Dodd-Frank post that President Barack Obama left vacant.



REUTERS/Carlo Allegri

Fed Governor Dan Tarullo has in effect filled the role and has been one of the most ardent enforcers of Dodd-Frank. Few observers expect Tarullo to get the job, which opens the door to possibly a critical shift in the enforcement of existing rules.

Trump will have the opportunity to name new heads of the SEC and the Commodity Futures Trading Commission (CFTC), and appoint Republican majorities. They will scrutinize how existing rules will be interpreted and enforced, as will the prospective leaders of the other banking regulators, such as the Office of the Comptroller of the Currency (OCC).

Paul Atkins, a former SEC commissioner, has led Trump's transition on regulatory enforcement issues, and if his past experience is any guide, there is likely to be a lighter touch in dealing with firms. Atkins was an outspoken critic of regulations that forced hedge funds to register with the SEC and a requirement that independent chairpersons lead mutual fund boards. He also voiced opposition to imposing large fines on corporations, arguing that such sanctions disproportionately hurt shareholders rather than wrongdoers.

When it comes to pursuing white-collar crime, however, Trump's decision to ask Preet Bharara, U.S. attorney for the Southern District of New York, to stay on suggests a desire to maintain a tough approach to insider trading and other forms of corporate wrongdoing.

SELF-INTEREST ABROAD

Foreign policy under the Trump administration will return to what might be called "national solipsism," with a much narrower definition of American interests and a reluctance to act in the world except to protect those narrow interests, Brookings Institution scholar Robert Kagan has written.

"To put it another way, America may once again start behaving like a normal nation," Kagan said. "Trade deals should be about making money, not strengthening the global order or providing reassurance to allies living in the shadows of great powers. The U.S. is no longer in the reassurance business."

If one extends Kagan's analysis to international financial regulation, there will be less subservience to bodies such as the Basel Committee on Banking Supervision/Bank for International Settlements or the post-crisis Financial Stability Board.

The United States will only abide by or follow proposals from such forums if they serve the interests of U.S. financial institutions. Pushback to such organizations has already been evident in Europe; it is likely that the United States will follow.

"There is a lot of sentiment that the Fed and [the Financial Stability Oversight Council] have been agreeing to global rules that don't make sense in the U.S.," said Karen Shaw Petrou, managing partner of Federal Financial Analytics, a consultancy in Washington, D.C.

An important test of such sentiment this year will be the so-called Basel IV capital standards, reforms intended to take Basel III requirements even further. One of the major concerns is a requirement that would force banks to use so-called "standardized models" when calculating their capital ratios rather than internal models that allow banks to risk-weight their assets. This is seen as a further cost that many banks are lobbying against.

"If the U.S. regulatory agencies agree that we go to the Basel IV standardized approach, then I think legislation would be introduced to repeal that," Shaw Petrou said. "I think that will take time, but that is what I think will happen."

The Basel Committee failed to reach agreement at the end of November on the proposal, which puts the spotlight on 2017 and the new U.S. administration.

FINANCIAL TECHNOLOGY

U.S. regulation could have a profound impact on the burgeoning fintech sector and on disruptive forms of technology such as blockchain, the distributed ledger technology that promises to transform payments, clearing and settlement functions. The growth of nimble firms aiming to compete with larger, regulated banking organizations challenges regulators, as they weigh potential benefits of new products and forms of technology against the need to ensure safety and soundness.

Under pressure from the fintech industry, the OCC has proposed a "special purpose banking charter" for fintech companies and firms engaged in payment services, lending or other bank-like activities. Many questions exist regarding the regulatory requirements such firms will face, and those with a special purpose charter will need to join the Federal Reserve system. The Fed has so far taken a more cautious approach toward financial innovation.

A clearer view may also emerge regarding blockchain. A much-awaited Fed paper late last year said blockchain offered substantial opportunities to reduce banking system costs, but also said several legal, governance and market structure issues have yet to be resolved. The Fed's stance toward blockchain could be greatly influenced by Trump appointments.

PREPARING FOR REGULATORY CHANGE

Even the most ardent critics of post-crisis reforms would agree that certain forms of regulation have benefited their organizations. This might be especially the case when it comes to curbing bad behavior. All of the systems and tools put in place to better monitor transactions and employee behavior have minimized the risks associated with market manipulation and collusion, which can easily cost a bank billions in losses and fines, as has been amply demonstrated.

With key policy makers at the regulatory agencies still to be appointed and confirmed, the best course for compliance may be to hold off on any rash decisions to scale back existing functions and processes. What is prudent, however, may be to monitor the fate of outstanding proposals that may not see the light of day, as well as keep a sharp eye out for signs of new change in the regulatory landscape.

According to an analysis by the law firm Davis Polk, of the 390 rulemaking requirements under Dodd-Frank, 275, or 71 percent, have so far yielded finalized rules. Still outstanding are proposals regarding single counterparty credit limits, incentive-based executive compensations, and various rules regarding swaps trading, such as Reg AT, which the CFTC has under review.

Given the existing uncertainties, it might make sense to put projects on yet-to-be completed rules in a holding pattern and await what will undoubtedly be an unpredictable path toward a new regulatory era.



REUTERS/Mike Segar

U.S. REGULATORY ENFORCEMENT SIGNALS ARE MIXED AS TRUMP TAKES OVER

Change at the top in Washington always challenges the financial industry with combing the political track records of the new boss to assess the regulatory impact. This time, the record for predicting Donald Trump's presidency is unclear, particularly when it comes to enforcement.

Compliance and legal teams say they expect a busy period sorting through mixed signals sent by Trump's team and his fellow Republicans in control of Congress. Trump has vowed big changes to the status quo but offered few details, at a time when the financial industry is seeking to emerge from a period of multibillion dollar enforcements brought by a wide range of state and federal regulators.

"The sum of our knowledge about how Trump will enforce securities laws is less than zero," said a partner at a top New York firm. "He's taken a lot of contradictory positions in the campaign. Right now I don't know what to say when clients call."

Trump's team has been seeking ways to unshackle economic activity while also remaining true to the anti-Wall Street populist sentiment that fueled his presidential election victory.

"There is a strong theme of deregulation but also a theme of populism, and helping people on Main Street," said Michael R. Patterson, a principal in EY's financial services compliance consultancy.

Trump has criticized Wall Street for "getting away with murder" but also called for spurring bank lending with a major rollback

of the 2010 Dodd-Frank regulatory overhaul. "The questions outnumber the answers," Patterson said.

Because Trump has no track record in political office, risk professionals are attempting to assess him based on his business background.

"There is a randomness in dealing with somebody in the financial world who does not come with an agenda," said Meryl Wiener of Warshaw Burstein, a securities lawyer and former SEC attorney.

Some clarity has emerged. Top positions are being filled, and high-profile resignations are being tendered. Among the significant moves is the planned departure of SEC chair Mary Jo White, who led an enforcement crackdown fueled by new data tools and a "broken-windows" philosophy of cracking down on small violations to deter big ones. Andrew Ceresney, the SEC enforcement chief who ran the program, also announced his departure.

There are also a few likely areas of continuity in enforcement. Compliance teams are using those as a starting point, Patterson said. He cited anti-money laundering (AML) and consumer-facing bank regulations as probably durable. Enforcement of abusive sales practices by brokers is also unlikely to see any major shift.

The financial regulation leader of Trump's transition team, former SEC commissioner Paul Atkins, has supported the role of self-regulators such as the Financial Industry Regulatory Authority (FINRA) in overseeing member firms in the brokerage industry. The transition team called for eliminating regulatory

overreach while still “protecting consumers by policing markets for force and fraud.”

DEREGULATION BY RELAXED ENFORCEMENT

A Trump administration may see relaxed enforcement as an alternative to formal deregulation. It offers the impatient mogul a quicker way of enacting policy than the plodding work of rewriting rules. There is already talk this strategy will be used to defang the Volcker Rule banning proprietary trading, and of making enforcement a low priority, according to sources close to Trump’s transition team.

A relaxed enforcement strategy also would allow Trump to avoid Congress. With Democrats retaining power in the Senate to block some legislation, Congress could still slow a push for deregulation.

Regardless of Trump’s policy approach, the SEC has made strides to streamline enforcement and increase its impact in ways likely to endure. The SEC and the CFTC are independent government agencies. Trump’s authority over them is limited to making appointments and ensuring the commissions have a Republican majority.

The SEC under White has used a strategy of piling up evidence of securities law violations to persuade defendants to reach faster settlements. Use of big data analytics has added efficiency and lower-cost enforcement that wins settlement cash to pay its own costs. Conduct and banking regulators have also improved cooperation and added technical capabilities.

WATCH APPOINTMENTS

Trump’s team has played down any rhetorical contradictions as normal in political campaigns and says to watch his actions and appointments to understand his governance.

Republican Senator Jeff Sessions of Alabama, a former federal prosecutor, was Trump’s choice for U.S. Attorney General, the top federal enforcement authority. Sessions is an enthusiast for the Department of Justice’s “Yates Memo” emphasizing individual culpability for corporate malfeasance.

He is also an advocate for stronger prosecutorial powers and has a history of taking on banks. “A prosecutor cannot be a weak-kneed person going up against a major corporation in a fraud case,” Sessions said at a congressional hearing before he was nominated.

Even more telling, Preet Bharara, scourge of Wall Street misbehavior, is staying on as U.S. Attorney for the Southern District of New York. A Supreme Court ruling in December may give Bharara’s signature crackdown on insider trading new life after an enforcement lull.

Other appointments have shown friendliness to the financial industry. Former Goldman Sachs partner and hedge fund investor, Steven Mnuchin, was named to head the U.S. Department of the Treasury, a key enforcer against money laundering and illicit financial transactions.

Atkins, a Republican loyalist, has guided the transition team on a predictably pro-business path. Both are seen as pragmatists who understand banks and brokers. Mnuchin lacks any government experience, but Atkins has Washington credentials as a former top regulator.

COMPLIANCE ROLE

Some see the role of financial services compliance programs coming into question as a Republican president with a congressional majority scales back on regulation and uncompromising enforcement.

“The big question that remains is whether potentially reduced levels of fines could reduce the urgency,” said Dan Zitting, chief product officer at ACL, an audit and risk firm.

In the near term, however, compliance may well find its importance growing as banks and brokers call on their compliance professionals to stay on top of regulatory changes and to update programs. Furthermore, the rise of international enforcement bodies, particularly those with authority over bank money transfers and corruption, and a newfound assertiveness by legal authorities in U.S. states are likely to keep compliance on the front lines regardless of shifts in U.S. federal policy.

A need to stay on top of the changes will affirm the role of compliance in the future for what could be a volatile time. Compliance can prepare by basing risk assessments first of all on what one can be sure of.

“Anyone in compliance should be on top of their businesses right now – I know I’m not going to take more vacation time. I’m not going anywhere,” Patterson said.

Enforcement may be the domain of legal counsel, but compliance must be ready with sturdy record keeping, training and internal controls.

“For the little guys at the bottom in the enforcement agency, it will be business as usual,” Weiner said. “When it comes to enforcement, you don’t really start with a clean slate. Investigations will go on because you can’t just walk away from them.”

Compliance, as usual, will be sitting across from them at the table.

“Anyone in compliance should be on top of their businesses right now – I know I’m not going to take more vacation time. I’m not going anywhere.”

Michael R. Patterson
EY



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BANKS SEEK INTERNATIONAL VIEW OF CUSTOMERS IN KEY CHALLENGE

Under intense pressure to improve their controls against money laundering and other illicit financial transactions, multinational banks – many operating under consent orders from U.S. regulators – are struggling to gain a unified view of their customers to ensure they know all the products and services the individual clients are using.

The push for this “unified customer view,” a proposition that can easily cost hundreds of millions of dollars, is a high priority for banks’ know-your-customer (KYC) compliance units in the new year.

“Every big bank is trying to do it with varying degrees of success, and it’s going to be a long time before any bank has this right,” said a former AML compliance officer with an international bank who is now a consultant and familiar with the efforts of several large banks.

The challenge is especially daunting for banks headquartered outside the United States that have large U.S. dollar-clearing operations. They need a unified view of customers just to avoid having their investigative teams around the world unwittingly probe the same suspect transactions, and thus sow “complete schizophrenia” within their AML programs, said the compliance officer turned consultant.

An AML compliance officer at one bank facing this struggle said, “U.S. regulators expect banks to understand each customer’s activity, and to understand it, they must be aware of all of the customer’s activity.”

Problems with customer data quality and completeness, scarce information about the true, or “beneficial,” owners of accounts, data privacy laws, incompatible systems assembled via decades of mergers and acquisitions, and other hurdles are making it difficult for international banks to determine their entire exposure to certain clients. That leaves the risks murky for money laundering and other financial transaction violations.

Many of the challenges “stem from mergers and acquisitions and lines of business being siloed,” said a U.S. large-bank examiner. “It was not until 2008 or 2010 that banks began to think of customer due diligence globally,” he added.

Speaking at a recent AML conference in Washington, Joseph Ciccolella, global KYC officer with JPMorgan Chase Bank, said the U.S. banking giant was turning to legal entity identifiers (LEIs) to track customers across lines of business. As banks collect information about beneficial owners, these “new names we’re integrating or adding to our population have a unique identifying number,” he said.

“That is a definite big-bank challenge. We can all just give a person a number, but how do we distinguish between one [Jane Doe] and another [Jane Doe] to make sure that we’re properly merging that record, so we can tell when [Jane Doe] is a customer and a beneficial owner as opposed to when we have to keep her separate because she’s not the same person?” Ciccolella said.

“When you have 500 million accounts and customers including credit cards and loans and all that in your database, it’s not easy to tell [one Jane Doe from another],” he said.

"When you have 500 million accounts and customers including credit cards and loans and all that in your database, it's not easy to tell [one Jane Doe from another]."

Joseph Ciccolella

JPMorgan Chase Bank

"It's a huge challenge. So as your account-opening people in operations are adding these names to your files, [one must] teach them how to distinguish between one person to another."

RECORD REMEDIATION

More difficult still are the millions of legacy accounts held by the large banks, many of which have incomplete customer profiles, some missing even customer names, the bank examiner said. A large bank that has acquired several institutions through the years may find in its history "one bank that collected good data and several others that really didn't care."

"They just threw their records in a pit somewhere and put the customer's first name and middle initial for your record," the source said.

As a result, the first step banks must take is to "backfill" deficient customer data files. Where possible, banks can rely on third-party KYC vendors for help, as long as regulators agree. In some instances, banks must go back to customers to fill in the blanks.

"There are accounts at some banks where they don't have a name on the account. I don't know how that happens, but it does," the bank examiner said. "So all you have is a telephone number and I guess you call and say, 'Hey, I need some information.'"

Once each line of business has updated its records, it is time "to marry the information together," the source said, echoing senior compliance officers, who all seem to agree that LEIs are the best way to track customers worldwide.

"A unique identifier for the customer is a good way for us to . . . manage a customer going forward, but we have a long way to go and I think the industry is still learning on how to do that," said Barbara Patow, the London-based global head of AML at HSBC.

New technology will play a vital role in success, as will so-called "utilities" that allow banks and other companies to partner in storehouses of customer information for KYC purposes, Patow said.

"You have your existing customer base and you also have your new-to-bank customers. Banks like ourselves are driving toward the new standard, a single customer view globally, but you do need that technology," she said.

Even when banks have achieved a higher KYC standard, they will need to make the new technology fit within their existing compliance frameworks, Patow said.

"You have to make sure that all of your downstream systems, your transactional systems, align to that KYC. How we can mature that process is something I think all banks are looking at," she said.

Citibank's push to develop a singular view of customers through its so-called OneKYC Program is perhaps the most widely known effort to gain an international view of customers. While Citi did not respond to a request for comment for this article, job postings online offer a window into the motivation behind its efforts and the scope of the program.

"As part of Citi's commitment to comply with Consent Orders issued by [the OCC] and [the Federal Reserve Board] impacting Retail and Cards businesses, a global initiative has been rolled out to deploy OneKYC Program to meet regulatory requirements regarding KYC and Transaction Monitoring," Citi stated in an expired posting for a KYC program leader to cover 17 markets.

Cooperation between banks will be a major key to success as institutions seek to develop and use an international view of customers, Patow said.

"It's important the banks are working together to drive and to learn the lessons. If we find a good way to do KYC, we should share that with other banks; it shouldn't be something we hold dear to ourselves," she said.

STANDARDIZATION AND CLARITY ARE CLEARINGHOUSE PRIORITIES

Having long recognized the benefits of central counterparty clearinghouses in enhancing market transparency and mitigating counterparty credit risk, and their increasingly pivotal role as the "central nervous system" of financial markets, regulators have overcome inertia on both sides of the Atlantic with a flurry of regulatory initiatives.

These initiatives are geared at gauging the systemic risks pertinent to central counterparties, or CCPs, and accordingly, at drawing up measures to contain them. This is most notable through a push for standardization among CCPs and streamlining the resolution and recovery processes. The momentum will continue through 2017.

The European Commission has recently proposed a CCP recovery and resolution framework. The proposal would require clearinghouses to draw up recovery plans, grant regulators specific powers to intervene in their operations when warranted, and establish "resolution colleges" to increase cooperation among European regulators and their counterparts across jurisdictions.

In the United States, the Commodity Futures Trading Commission has conducted its first stress tests of clearinghouses, evaluating the diversification of losses and the adequacy of their financial resources under multiple scenarios.

Additionally, international capital requirements for bank exposures to CCPs took effect with the new year. The requirements were drafted by the Basel Committee on Banking Supervision/Bank for International Settlements (BIS) in consultation with the BIS Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

The requirements specified a risk weighting for banks' trade exposure to the CCPs, with respect to their derivatives positions. They also addressed exposures of clearing members to their clients, as well as the treatment of posted collateral.

RESOLUTION AND RECOVERY

It is not yet clear, however, how regulators will proceed with the resolution of a systemically important CCP that faces financial collapse.

Although CPMI and IOSCO have provided some guidance in their Principles for Financial Market Infrastructures (PFMI) and in subsequent works, details are vague. Particular areas of guidance have included non-default loss allocation – the operational and investment losses attributable to the CCP rather than CCP members – and the reestablishment of a matched book following a participant default. Guidance has also covered how quickly financial resources are to be replenished after a member defaults.

A number of CCPs lack recovery plans, nor do they disclose how recovery tools would be used under different scenarios resulting from default and non-default losses.

Consensus remains to be achieved on issues pertaining to:

- The “point of entry” for CCP resolution, whether at the level of the holding company, the intermediate holding company or the operating company
- Whether clearinghouses should retain their powers to distribute losses among clearing members; options include imposing a “haircut” on cumulative variation margin (VM) gains on the portfolio of trades of each beneficial member account, a partial tearing up of contracts upon entry into resolution, or transferring a defaulted clearing member's client positions to a non-defaulted clearing member rather than closing the positions
- A clearly defined hierarchy of loss allocation
- Cross-border cooperation issues between multiple resolution proceedings in separate jurisdictions

STANDARDIZATION

Last year, U.S. and European regulators reached an “equivalence decision” allowing reciprocal operational recognition for CCPs in both jurisdictions regardless of their home country registration.

This was a step toward creating a level playing field. Much remains to be done to improve comparability among CCPs and alleviate conflicts and inconsistencies that can cause regulatory arbitrage.

CCPs differ significantly from one another in terms of how they construct models for margin calculations. They also display considerable divergence in testing methodologies and data used to determine the size of any fund used to cover defaults.

Areas of input data divergence include contract closeout periods, correlation offsets among different asset classes, the treatment and weighting of historical data, and the structure of value-at-risk models.

Regulators are not necessarily looking for one-size-fits-all criteria in models. They recognize CCPs cover different asset classes in different markets, but regulators and CCP members tend to agree that the industry would benefit from the adoption of consistent minimum common parameters.

Similar divergences exist in variables and assumptions used in internal stress tests at the CCPs. So far, no agreement has been achieved on the definition of “extreme but plausible” scenarios, a key term upon which many of the PFMI are built. The PFMI, which were the result of a joint effort in setting standards by the BIS, IOSCO and the CPSS in 2012, were updated last year with the participating organizations providing more detailed guidance.

CCPs' loss-sharing mechanisms also vary greatly. In contrast to their European counterparts, most U.S. CCPs collect higher initial margins and require more contributions for default funds from their clients. This is a result of the legally segregated, operationally commingled (LSOC) model that the United States has adopted. This model disallows using non-defaulting clients' collateral to cover a defaulting customer's losses, thereby depriving CCPs of an important potential backup resource.

As for the “skin in the game,” European CCPs are required to allocate 25 percent of their own capital as part of funds to be drawn on in case of a member default. Again, no such requirement exists in the United States, and some CCPs do not even use capital as part of their layered default system, or “waterfall.”

CCP capital, for those that include it in their waterfall, is usually used only after other loss-absorbing instruments, such as the initial margin and default fund contributions of the defaulting member. Yet, knowing the CCP has its skin in the game would give its senior managers a strong incentive to monitor its risk management practices more closely and help align its interests with those of its members.

Lastly, some European CCPs benefit from an explicit central bank backstop facility in times of crisis (such as the Eurex Clearing, based in Germany, with guaranteed liquidity access to the Bundesbank). In the United States, CCPs enjoy no such resource. They instead have to rely solely on loss mutualization strategies among their members.

In carrying out their plans in these areas, regulators' success will ultimately determine the level of CCPs' systemic risk in the financial system and regulatory arbitrage opportunities that financial firms may exploit.

UNCERTAINTY ASIDE, U.S. ADVISERS WILL DISCLOSE MORE IN 2017

With a new U.S. presidential administration, uncertainty is looming regarding the future of investment adviser regulations. However, one initiative likely to follow its preelection implementation schedule is a series of requirements that compel SEC-registered investment advisers to give regulators more information about their activities.

Finalized in the summer of 2016, the changes are aimed at enhancing and modernizing the disclosures of SEC-registered investment advisers while also sharpening the SEC's focus on risk monitoring.

In particular, the SEC is requiring additional disclosures on its mandatory Form ADV related to separately managed accounts (SMAs), social media presence, physical offices and the use of an outsourced chief compliance officer.

The compliance date is October 1, 2017, meaning any initial Form ADV filing or amendment to an existing Form ADV will be required to provide the requested information after that date.

So firms this year will have an opportunity get their information and practices in order.

SEPARATELY MANAGED ACCOUNTS

A majority of the amendments are designed to collect more details on advisers' SMAs. The SEC defines SMAs as advisory accounts other than those that are pooled investment vehicles.

The amendments will require the adviser to report, on Item 5 of Form ADV, the exact number of clients it advises and the specific amount of regulatory assets under management (RAUM) attributable to each category of client, rather than providing only ranges as previously required.

Under the amendment, advisers reporting that they have assets under management attributable to SMAs must also report the approximate percentage of their SMA assets invested in 12 broad asset categories. The categories range from exchange-traded equity securities to securities issued by registered investment companies or business development companies, among others.

Advisers with more than \$500 million in RAUM attributable to SMAs will be required to report both the total amount and the level of borrowings attributable to assets of SMAs that correspond to one of three levels of gross notional exposure. Advisers with \$10 billion or more must expand the detail to derivative exposure across six categories, such as interest rate derivatives.

The amendments also require new disclosures regarding the number of adviser clients that do not have RAUM, as well as the

approximate amount of RAUM attributable to non-U.S. clients, wrap fee programs and all parallel managed accounts related to a registered investment company or business development company that is advised by the adviser.

Form ADV also requires investment advisers to identify any custodian that accounts for at least 10 percent of total RAUM attributable to such investment advisers' SMAs.

SOCIAL MEDIA PRESENCE

The social media requirements are intended not only to align the disclosure regime to modern practices, but also to enhance the exam process. The social media information will allow the SEC to compare information that advisers disseminate across different social media platforms, as well as to identify and monitor new platforms.

Form ADV will now require advisers to identify whether the firm has one or more accounts on social media platforms, such as Twitter®, Facebook® or LinkedIn®. Form ADV will also request the corresponding address of each of the adviser's social media pages.

The SEC has limited the reporting requirement to only accounts on publicly available social media platforms where the adviser controls the content. This is especially important, as advisers may be mentioned or referenced in other social media platforms over which they have no control. Lastly, advisers must now update Form ADV in a prompt manner when there has been a change in social media use.



PHYSICAL OFFICE

The existing Form ADV requests only general information about an adviser's principal office and place of business, and the address of its five largest offices. The amended form will require disclosure regarding the total number of offices from which an adviser conducts its advisory business.

It also seeks details about each firm's 25 largest offices in terms of employee numbers. It requires contact information, Central Registration Depository branch numbers, the number of employees in each office who perform advisory functions, identification of securities-related activities conducted from the office and a narrative description of any other investment-related business conducted from such office.

CHIEF COMPLIANCE OFFICER

Funds and investment advisers who outsource compliance functions received some new advice for this year in the form of observations issued by the SEC's Office of Compliance Inspections and Examinations.

The SEC urged funds and advisers with outsourced chief compliance officers (CCOs) to review their business practices in light of the risks noted in the alert to determine whether these practices are consistent with the advisers' compliance duties.

The SEC found in the 20 examinations of advisers using third-party CCOs that the compliance chief was occasionally left in the dark about a firm's business practices or risks, unable to access the firm's documents, and fell short in communicating with the firm and its principals.

The new Form ADV seeks more information concerning the individual acting in the CCO capacity. Form ADV previously only requested the name and contact information of an investment adviser's CCO; the new form will now require confirmation of whether the compliance head is employed by someone other than the adviser or a related person of the investment adviser and, if so, the name of that entity or person.

U.S. INSURERS FOCUS ON FEDERAL ROLE UNDER TRUMP, AMID STATE AND INTERNATIONAL INITIATIVES

The U.S. insurance industry will keep a close eye on federal policies this year, following the election of Republican Donald Trump as president.

Trump has swept into office on calls to deregulate the financial industry and scrap the "Obamacare" health insurance program enacted during the presidency of his predecessor, Barack Obama. Insurers will need to pay attention as his new administration and Congress address those high-ranking agenda items.

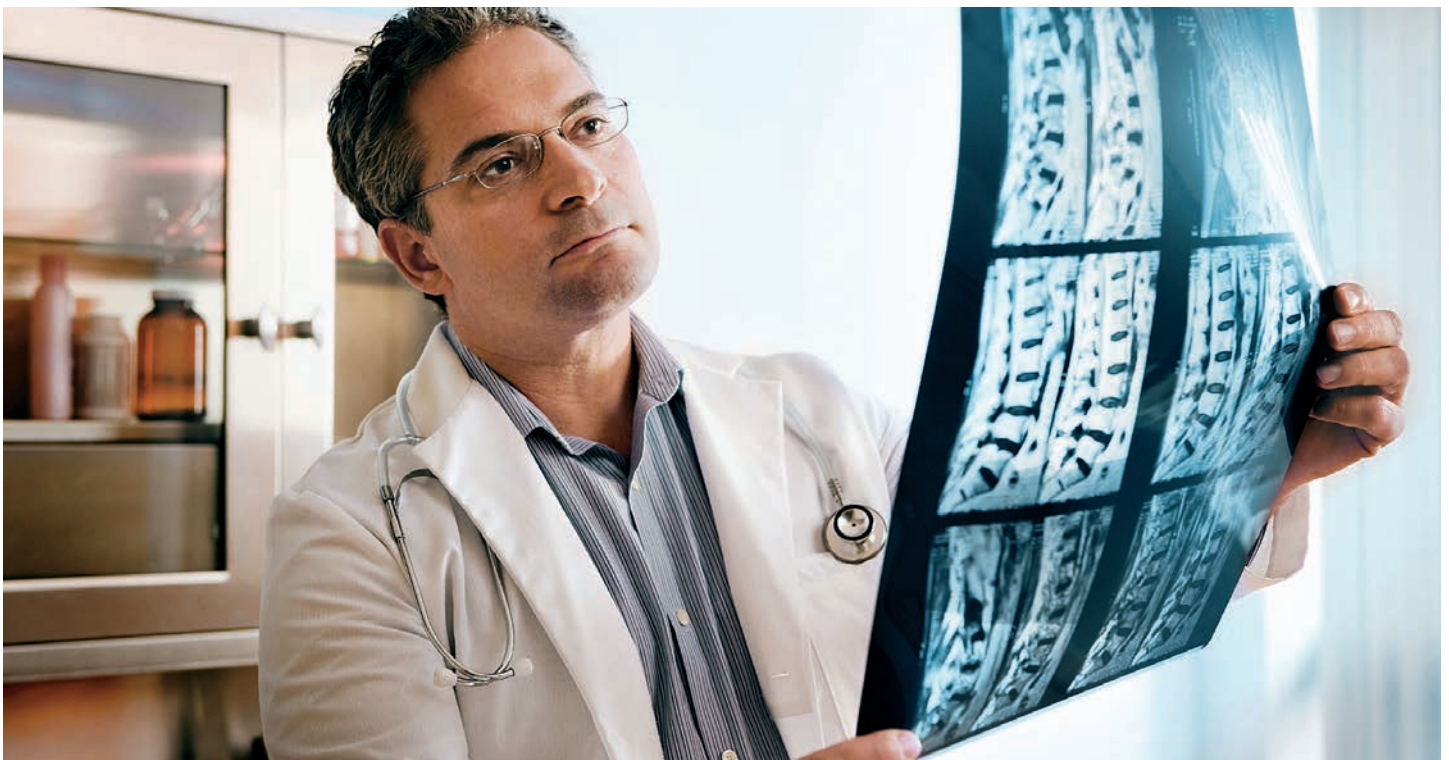
But initiatives internationally and at the state level, where most insurance business is regulated, will also shape the regulatory landscape for the U.S. insurance industry this year, raising issues ranging from self-driving cars to capital standards.

"It is an absolutely dynamic environment, and the playbook we thought we had written for the next four years is being rewritten as we speak," said Michael Consedine, a top Aegon executive who was hired in December as chief of the state regulators' body, the National Association of Insurance Commissioners (NAIC).

FEDERAL INSURANCE OVERSIGHT

What has been a growing federal role in insurance regulation could diminish under a Republican-dominated federal government. Trump's transition team has pledged to "dismantle" the Dodd-Frank Act of 2010, and Congress is already working on steps toward deregulation. A broad reversal of Dodd-Frank, while far from certain, could undo the Federal Insurance Office and the interagency Financial Stability Oversight Council, both of which increased federal oversight in the U.S. insurance sector.

One consequence could be that federal oversight of insurers' systemic risks may ease, giving a breather to big insurers subject to more stringent U.S. capital standards.



Also on the deregulation radar is the Department of Labor's new rule that sets a fiduciary standard for brokers who handle retirement accounts. The rule is scheduled to take effect from April 2017, despite objections from several sectors of the financial industry, including insurance. The Trump administration could try to rescind the rule, a potentially drawn-out process, or at least delay its implementation.

This could provide some relief to firms, but many have nonetheless geared up for implementation. While the rule is aimed at protecting consumers from brokers who sell products based on their commission potential rather than the client's best interests, it could disrupt life insurance industry models for sales of fixed and variable annuities.

HEALTH INSURANCE AND "OBAMACARE"

Trump campaigned on vows to repeal the Affordable Care Act (ACA), widely known as "Obamacare." He avoided mention of the issue in a postelection video statement on the immediate plans for his first 100 days in office and has raised the prospect of keeping some provisions. Decisions about its future are inevitable over the next few months, however, as the Republican party, which controls Congress, remains determined to "repeal and replace" it.

As much as the health insurance industry will be watching moves to repeal the law that provides insurance coverage to more than 20 million individuals, it will also be keenly interested in any follow-up plan to replace the ACA.

During the past six years, Republicans in Congress have made more than 50 attempts to repeal the law. Trump has selected House of Representatives Budget Committee chairman Tom Price, a leading Obamacare opponent and sponsor of repeal legislation vetoed last year by Obama, to head the U.S. Department of Health and Human Services, which oversees the ACA. This key appointment is a clear sign that efforts to dismantle the law will have executive branch guidance.

Obamacare, however, has a significant political constituency. Between November 1 and December 24 of 2016, coverage enrollments under the act rose by 286,000 – to 11.5 million total.

A poll by the Kaiser Family Foundation in November found only 26 percent of Americans favor a full repeal of Obamacare, while 30 percent of the public want to see it expanded and 17 percent would like to see the ACA scaled back. Suggestions by Trump and Price to date have included scaling back the law to cut costs and funding state assistance through block grants, which could hamper their ability to maintain similar levels of benefits.

There are three potential routes to overhauling the ACA:

- **A broad repeal:** This could eliminate coverage for 20 million Americans or more. Quickly replacing Obamacare with an alternative system would be logistically challenging for Congress, and any replacement plan will face political pressure to offer the promise of more effective coverage. A complete repeal of the ACA would also likely require a super-majority of 60 votes in the Senate, giving the minority Democrats blocking power.
- **A deferred repeal:** Quickly repealing the ACA, while delaying its effective date by a matter of years, could allow more time to devise and implement a replacement plan that offered new routes to coverage. Devising a replacement that would

avoid big reductions in the number of people covered while keeping federal budgets in check would remain challenging.

- **Amending Obamacare:** Some partial ACA changes can be made through a simple majority of votes in Congress. Such a process can be used, for example, to rein in federal subsidies to states for expanding Medicaid. The subsidies now bring millions of Americans under the fold of state-administered insurance coverage, but Republican opponents want to replace the open-ended, per-capita funding formula with limited block grants.

Simply amending the ACA, however, could draw charges from hard-line Obamacare opponents that the new administration and Congress were failing to fulfill campaign promises.

CONTRACEPTION AND ABORTION LAWS

Insurance coverage for contraception and abortion could face new restrictions under a Republican-dominated government. While Trump during the transition shed no light on any plans for regulations that would either limit or ban insurance coverage for reproductive matters, the industry will be watching closely.

MEDICATION

Although pharmaceutical company shares climbed in response to Trump's defeat of Democratic presidential candidate Hillary Clinton, who had called for a clampdown on drug prices, top industry executives have called for self-policing on drug price increases. They warned of Trump's potential to use his Twitter feed to launch a public backlash against high prices. Any restraint in prescription drug prices could provide some relief to insurer costs and increase competition among carriers.

MARIJUANA

The fate of legalized marijuana is being watched by insurers in the medical and property-and-casualty fields. Despite gains for recreational and medical marijuana legalization in state referendums in November, it remains illegal under federal law. Insurers are reluctant to provide coverage for legal businesses, prescribed medication and research in the marijuana industry. They will be watching out for any changes in federal policy before the industry begins to consider offering coverage related in any way to marijuana.

Trump's pick of Alabama Senator Jeff Sessions, who has spoken against marijuana legalization, to be Attorney General has clouded the prospects for any softening of the federal legal structure.

STATE INITIATIVES

At the state level, regulators will be working to overcome obstacles to a framework for insurance industry cyber security rules. The NAIC and the industry have been unable to reach consensus on a new cyber security model law to protect carriers and consumers against the breach and misuse of crucial personal data. They missed a December 2016 target for adopting a model law, which is now expected sometime this year. The insurance industry has called for a model law that sets a "regulatory ceiling" for compliance, to bring order to the 48 different data-breach laws already on the books in various states.

The prospect of self-driving "autonomous" cars will gain increasing attention from state regulators. The automobile industry and technology giants are working overtime to put a

fully autonomous commercial vehicle on the road in 2018, and insurance regulators want to be prepared. Questions on higher costs of repair, owner liability and passenger safety in the event of machine error have dominated the work toward a regulatory solution.

State regulators are also working on updating regulations for the long-term care insurance industry and working on other retirement security initiatives. These are driven by reductions in individual savings that promise to increase reliance on Social Security benefits and government health programs during retirement.

INTERNATIONAL

Besides the domestic issues, the U.S. insurance industry will be monitoring the International Association of Insurance Supervisors (IAIS), which is working on capital standards for internationally active insurers and systemically important firms. The IAIS has spent more than a year developing the proposed regulations, which are aimed at preventing a large-scale financial crisis. The IAIS is committed to completing by mid-2017 an initial version of its standards that can be confidentially “field-tested” by international insurance businesses.

U.S. insurers will be closely monitoring their proposals for practicality of compliance as they are already subject to multiple state laws.

CANADA'S UNIFICATION OF REGULATORS PUT ON ICE AFTER NATIONAL EFFORT STALLS

Canada's effort to launch a national securities regulator has been put on hold, leaving the country as the only Group of 20 advanced economy without a national market authority. The established securities commissions and self-regulating organizations, therefore, will forge ahead with their existing regulatory initiatives in 2017.

The Cooperative Capital Markets Regulatory System, proposed in 2013 to establish a national regulatory umbrella, was scheduled to begin operating in June 2016, but participating authorities have postponed the launch until at least 2018. In the Canadian context, this delay can be viewed as indefinite.

The centralized regulation mechanism was intended to replace the patchwork of 13 separate securities jurisdictions, but securities regulation will now remain in their hands for the foreseeable future.

In 2017, Canadian regulators will continue advancing a dual-track strategy of facilitating innovative capital formation methods while strengthening conduct standards to improve the client-registrant relationship.

FINTECH AND CROWDFUNDING

The Ontario Securities Commission (OSC), Canada's most influential regulator, recently took the bold step of providing direct support for financial technology, or fintech, startups. Called the “OSC LaunchPad,” the program will provide compliance advice, flexible regulations and time-limited



exemptive relief, or “regulatory sandbox,” for testing innovations in real-world settings.

The commission has pledged to help securities-related fintech businesses navigate the regulatory environment and quickly get to market. Additionally, the OSC and other Canadian securities authorities will continue monitoring exempt market activity, after introducing major prospectus exemptions for smaller issuers throughout 2015 and 2016, including several equity crowdfunding regimes. More effort will go into understanding how those new capital-raising methods have affected startup issuers relative to rapidly evolving investor needs.

The resulting combination of market innovation, inexperienced investors and a growing elderly population will increase reliance on professional advice and, therefore, have important investor protection implications. Accordingly, Canadian regulators are sharpening their focus on registrant duty and conduct issues.

BEST INTEREST STANDARD

A years-long drive to enhance firms’ obligations to clients gathered considerable momentum in mid-2016, with recently updated proposals for targeted, prescriptive and enforceable regulatory reforms. Additionally, Canada’s securities standard-setter, a council of regulators, is nearing a decision on whether to introduce a national best interest standard for all registrants. Despite the consensus for prescriptive reforms, there remains disagreement among jurisdictions on the need for an overarching standard that would guide the interpretation of all client obligations in Canada.

Demonstrating a sense of urgency, securities commissions are already acting on conflicts management issues, particularly through compliance sweeps focused on incentives that favor the sale of certain products over others. Regulators will additionally continue to focus on proper suitability assessment practices, protection of elderly clients and compliance with enhanced disclosure requirements. A parallel effort to introduce a statutory best interest duty, which would essentially impose a fiduciary duty on advisers, appears to have stalled indefinitely.

RISK MANAGEMENT

Canada’s banking regulator, the Office of the Superintendent of Financial Institutions (OSFI), will further tighten prudential expectations regarding residential mortgage lending through increasingly risk-sensitive capital requirements and heightened supervisory intensity.

Capital requirements new this year for mortgage insurers include risk-sensitive floors tied to fluctuations in property prices and household incomes. Banks also have to consider the certainty of collateral property valuations. The new requirements are meant to address Canada’s increasingly high-risk housing market.

OSFI this year will continue its enhanced focus on prudent residential mortgage underwriting to ensure that lenders adapt their internal controls and risk management practices to account for market developments. Heightened expectations will focus on income and employment verification, high-risk loans, debt-service ratios, rigorous property valuation and the detection of changing risk dynamics.



Canada’s Prime Minister Justin Trudeau speaks at a meeting of the Calgary Chamber of Commerce in Calgary, Alberta, Canada, December 21, 2016

Reuters/Todd Korol

OSFI is also planning to “prune away” some corporate governance requirements for the boards of directors of banks and insurers. Having concluded that its task list for boards is long and occasionally inconsistent, OSFI determined that its approach could unintentionally create confusion and impede board effectiveness. The goal is to streamline and simplify its approach to governance.

ANTI-MONEY LAUNDERING PRESSURE

After receiving a scathing evaluation from the Financial Action Task Force (FATF) on money laundering and terrorism financing, Canadian authorities are under intense public pressure to increase effective enforcement and improve deterrence.

In June 2017, Canada’s regulator for anti-money laundering and counterterrorism finance issues, the Financial Transactions and Reports Analysis Centre (FINTRAC), will begin enforcing updated and streamlined KYC guidelines. These guidelines summarize client identification methods, record-keeping obligations and the appropriate use of third parties. Other authorities responsible for combating money laundering and terrorism financing, including law enforcement agencies and the federal government, have so far offered no concrete proposals on how to improve Canada’s performance.

FUTURE OF NATIONAL REGULATION

Despite announcing the delay to the national regulatory structure, participating jurisdictions nevertheless selected former TSX Markets president Kevan Cowan to be the initial chief regulator of the future Capital Markets Regulatory Authority (CMRA), keeping the project on life support. Cowan will also serve as the chief executive of the Capital Markets Authority Implementation Organization (CMAIO), which is responsible for transitioning to the new system.



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UK AND EUROPE

UK REGULATORS INVITE FIRMS TO PRODUCE INDUSTRY GOOD CONDUCT STANDARDS – AND THEN EMBED THEM

“This is, in effect, an invitation and challenge to the industry to articulate what high standards of conduct look like. It is an invitation for firms to join forces with each other, with official support, to create and apply standards, without the fear that a firm acting alone might find its efforts to achieve better conduct undermined by competitors superficially offering better terms to clients, or perhaps more generous incentives to their trading staff, but only able to do so because they are finding undisclosed ways to make inappropriate profit from those clients’ trading intentions.”

Edwin Schooling Latter, the Financial Conduct Authority’s (FCA) head of markets policy, was referring to the role industry should play in the FX Global Code market conduct standards being developed collaboratively across the world by regulators and industry following the foreign exchange market rigging scandals of two years ago. However, the British regulator’s evolving approach to conduct regulation, as Schooling Latter described to forex professionals in November, also applies more broadly across the wholesale sector.

The UK regulatory authorities are sending a similar “invitation and challenge” to firms throughout the wholesale fixed-income currencies and commodities (FICC) markets to develop and embed good practice in their corporate culture. This is to be guided by the standards that the UK’s FICC Markets Standards Board (FMSB) is developing.

Mark Yallop, the board’s chairman, said that practitioner-generated standards address the lack of any conduct guidance between “high-level principles at 75,000 feet and the 5,000-foot-and-below regulatory rules.”

“Such officially supported standards would give UK-based wholesale market practitioners an opportunity to fill this regulatory void,” Yallop told the British Bankers’ Association.

“That is potentially a way for London to distinguish itself, as the systemically most significant [financial] market center in the world, from what’s going on elsewhere, and underline the strength of the capital markets in London at a time when . . . they are under attack and challenge from a number of different directions,” Yallop said.

IT’S ABOUT STANDARDS

The FX Global Code aside, much standards-driven good practice will be related to activities well within the regulatory perimeter, and to firms’ implementation of, and compliance with, legislated regulation such as the Markets in Financial Instruments Directive/Regulation (MiFID/R) and the Market Abuse Regulation (MAR).

MiFID/R and MAR both contain relatively high-level requirements, which even “Level 2” implementation guidance from the European Securities and Markets Authority (ESMA) is unable to distill into one-size-fits-all hard rules for every type of market participant and business model.

Examples in MiFID/R that leave room for firms to make their own judgments include high-level prescriptions about product governance, the compliance function, complaints handling, conflicts of interest, underwriting and placing allocation policies, and, for the first time in the new MiFID directive, algorithmic trading.

Examples of these kinds of requirements in MAR include how firms design market abuse and market manipulation surveillance systems, and how they decide whether specific client communications constitute an “investment recommendation.”

These Level 1 rules abound in terms such as “adequate policies and procedures,” “appropriate rules,” “effective organizational and administrative arrangements,” and so on. ESMA’s Level 2 text and its safe harbor guidance in the form of answers to model practitioner questions (Q&A) are supposed to flesh out these high-level prescriptions, but they will clearly never entirely do so. The frequent use of non-exhaustive lists of compliance criteria in Level 2 text confirms that this is not even ESMA’s intention.

Nor will the FCA’s own handbook, although legend has it that it would stand six feet high if printed, ever have all the answers for every compliance quandary.

“No amount of guidance could address every permutation of every possible issue, so that ultimately, it is a firm’s culture which can really drive change, led from the top, but permeating throughout the firm,” said Karen Anderson, a partner in Herbert Smith Freehills’ global financial services regulatory practice, and chair of the City of London Law Society’s (CLLS) regulatory law committee.

“There is a clear recognition that even with the development of industry standards such as the FMSB’s, the key is embedding the codes and standards within firms, and for firms across the board to apply standards uniformly – without the fear that competitors will not do so,” Anderson said.

MAR, which applies directly to each European Union member state without the need to be transposed into national legislation, has replaced the UK’s previous domestic market abuse regime. Because it is a directly applicable regulation, not a directive, the FCA’s ability to provide guidance to the firms it regulates is limited, and it has deleted much of its former guidance from the handbook, leaving it to the industry to develop an informal domestic Q&A process. (A similar UK industry exercise in relation to the first MiFID produced the somewhat humorous concept of “sturdy breakwater,” i.e., something short of a formal safe harbor.)

“Faced with the uncertainties surrounding the interpretation of MAR, the FCA certainly did not discourage industry associations and the CLLS from producing Q&As to assist the industry, and although they would not ‘approve’ them, they were willing to provide a degree of informal feedback on them,” Anderson said.

WELCOME FLEXIBILITY

“The industry welcomes flexibility in regulation and the ability to create its own best practices and to discuss these with the regulators,” said Will Dennis, head of compliance at the Association for Financial Markets in Europe (AFME).

“This is, in effect, an invitation and challenge to the industry to articulate what high standards of conduct look like.”

Edwin Schooling Latter
FCA

“This applies not just to the FCA but also to the 27 other national competent authorities (NCAs) across Europe. Examples include some areas of MiFID and MAR which represent compromise positions which are very difficult to translate into clear and unambiguous regulation, and so industry initiatives are very important.”

Dennis pointed to the Joint Money Laundering Steering Group (JMLSG), to which all UK financial services trade bodies belong, as a further and important example of collaboration between the private and official sectors, whereby the British government endorses JMLSG guidance to firms on interpreting UK money laundering regulations.

In his speech to forex professionals, Schooling Latter said market participants would need to do better in the future on adherence to codes such as the FX Global Code. He reminded them that the UK’s Senior Managers and Certification Regime (SMCR) called for all those covered by it, as well as those covered by the updated conduct rules, to observe “proper standards of market conduct.”

“[M]arket participants can reasonably expect the code to be a key component of these proper standards of market conduct,” he said.

“Individuals, whether senior managers, or traders, would therefore be ill-advised to forget this code. And authorized firms should be prepared for future FCA interest in how they have made sure that their staff are aware of the code and behave in accordance with it.”

ESMA’S AMBITIOUS REFERENCE DATA PROJECT CRITICAL TO MIFID II SUCCESS

The main reason given for the one-year delay to the application date of the Markets in Financial Instruments Directive II was ESMA’s need for more time to build a reference data system to sit at the heart of its transaction-reporting regime. This year will determine whether ESMA can deliver its financial instrument reference data system. Known as FIRDS, this vast reference data project is in effect the engine at the heart of many of MiFID II’s most complex requirements.

A year ago, ESMA estimated FIRDS would not be completed until the third quarter of 2017, and it had not set out a public timetable for modifications to its Transaction Reporting Exchange Mechanism (TREM). ESMA also warned transaction reporting would not be viable without the appropriate reference data systems in place. Many aspects of MiFID II will fail unless



Reuters/Jon Nazca

the reference data system project is completed on time. FIRDS's success is critical to the whole MiFID II project.

"The FIRDS system is crucially important. It doesn't just impact transaction reporting. It impacts other components of MiFID II: transparency and liquidity thresholds, position reporting for commodity derivatives and various other aspects of the regulation. For example, some of the requirements related to algorithmic trading are also dependent on this. It's fundamental to the new regulation coming in," said Simon Appleton, regulatory reporting specialist at Duff & Phelps.

As this report went to press, with a year to go before MiFID II's enactment, ESMA had not yet finalized a timetable for FIRDS's completion and the commencement of testing.

An ESMA spokesman said both systems are being built and tested, and will be finalized in 2017. There will probably be different phases of implementation for different modules later in the year. FIRDS is likely to be implemented earlier than the TREM update.

ESMA'S AMBITIOUS REFERENCE DATA PROJECT

The FIRDS project centralizes reference data collection required by MiFID II by permitting ESMA to collect it directly from venues on behalf of all but six national competent authorities (NCAs) or regulators. That requires direct connection to at least 100 trading venues and possibly another 400 through NCAs. FIRDS will collect and process reference data, International Securities Identification Numbers (ISINs), for an estimated 15 million instruments compared with about two million under the existing MiFID regime.

Once finalized, the database will allow regulators and market participants to access all data for financial instruments traded on EU-regulated markets or MiFID venues. It will show which instruments require transaction reports, and the data will be used to calculate data also used for other purposes, for instance for the calculation of transparency and liquidity thresholds as well as for position reporting of commodity derivatives.

"Work on this major project, which requires ESMA to connect to hundreds of trading venues across Europe, is on track and is planned to go live in time with the application of MiFID in 2018. This project will allow us to collect data in a more efficient and harmonized manner across Europe, thereby achieving five important economies of scale and lowering costs for industry and taxpayers, and publish all transparency parameters and reference data on financial instruments in a one-stop shop," Verena Ross, ESMA's executive director, told TheCityUK conference last May.

Ross indicated the project was on schedule but warned that pending legal certainty on final Level 2 measures, and in particular those specifying the transparency requirements, it was difficult to develop the requirements and functional specifications for the FIRDS project.

As it turned out, those regulatory technical standards (RTS 1 and 2) were finally adopted by the European Commission in July, although they have yet to be published in the *Official Journal of the European Union*. That same document shows RTS 20 and 21, both related to commodity derivatives, have yet to be adopted by the Commission. An ESMA spokesman did not

respond to a request for comment on the timetable for FIRDS completion, or when testing would start.

“To what extent FIRDS will be up and running on day one is hard to say at this time. There could be slippage which could create a large number of rejections if ISINs aren’t captured by ESMA and the NCAs within seven days of a transaction being reported. If firms report with ISINs that haven’t been captured by the NCA, it will place the relevant transactions in a pending queue for up to seven days after which they will be rejected if still not available,” said Zach Johnson, regulatory reporting specialist at Duff & Phelps.

In October, ESMA published 110 pages of instructions for regulators, trading venues, systematic internalizers and data reporting service providers (including approved publication arrangement and consolidated tape providers), who are going to implement system interfaces for the uploading of data to FIRDS.

Up to 500 potential venues will need to report ISINs to ESMA or a national regulator at the time the transaction is executed. NCAs will need to compress that data and send it to ESMA the same day. ESMA will then process that data by 8 a.m. the following day to publish itself and to return to NCAs to ensure their ISIN database is up to date.

“It’s a hugely complex machine to process all of that data and make sure all the venues are meeting their disclosure requirements, and that pipeline and system flows are in place and accurately processing the data. Trading venues must meet their obligation to provide the ISINs to NCAs, who must process these and forward them on to ESMA in a timely fashion,” Johnson said.

EMIR DATA PROBLEMS SERVE AS WARNING

What ESMA and the industry want to avoid in MiFID II reporting is a repeat of the fiasco that was European Market Infrastructure Regulation (EMIR) trade reporting.

ESMA’s recent discussion paper, “The trading obligation under MiFIR,” shone a light on the poor-quality data collected under EMIR. The paper directly asked whether trade repository data was sufficient to determine how many firms were trading in certain derivatives instruments. ESMA also indicated it would seek additional data to complete MiFID II liquidity assessments.

ESMA has learned from the EMIR trade reporting experience. It is embarrassing for the regulator when it cannot use data collected on its behalf to find out basics such as which firms are transacting in certain instruments. According to the information that has been received on FIRDS so far, as well as knowledge of how regulators, trading venues, systematic internalizers and data-reporting service providers are preparing to report ISINs, there is cautious optimism that ESMA’s big project is progressing to plan.

FCA TO PRIORITIZE FINANCIAL CRIME, INSIDER DEALING AND AML

During 2017, the FCA will direct new data science tools to detect insider dealing, market manipulation and money laundering. The regulator set these priorities out in its mission statement last year. As Ian Mason, legal director at DLA Piper, has suggested, a first case under the MAR will make the FCA

look good. As of March 2016, the FCA had 55 market abuse cases open.

The FCA may receive help from the cross-governmental task force on the Panama Papers, which in late 2016 had identified leads relevant to a major insider trading operation led by the regulator. Guy Wilkes, partner at Mayer Brown, said the task force could establish communication links between insiders and those doing the trades, provide “follow the money” links and identify money via the Panama Papers, thus helping the FCA to recover proceeds of crime from individuals.

ENFORCEMENT ACTION

When dealing with firms, the FCA was likely to target enforcement action on weak systems and controls for AML and financial crime, Mark Steward, director of enforcement and market oversight at the FCA, told its crime conference in November. Steward referred indirectly to the £3.2 million fine the regulator had imposed on Sonali Bank in October as an example of such a failure.

The regulator wanted to know which senior managers in firms were responsible for AML, so if things went wrong, it would be able to see whether they personally had done the right thing, said Rob Gruppetta, head of the financial crime department at the FCA. The senior managers regime has had time to settle and Andrew Bailey, chief executive of the FCA, told the Treasury Committee in November 2016 that the FCA could start investigating senior managers in 2017.

CRIMINAL FINANCES BILL

The FCA participates in an AML information-sharing agreement with banks and the National Crime Agency (NCA) as part of the Joint Money Laundering Intelligence Taskforce, although Gruppetta said it would not use this route to probe firms’ participation in the existing arrangements. The FCA has, however, declined to clarify the approach it is likely to take once a legal gateway for information sharing is established under the Criminal Finances Bill, expected to become law in 2017.

Once the bill has been implemented, banks will want to ensure the basis for money laundering suspicion is recorded adequately, to protect themselves from litigation risk, according to Christopher Robinson, partner at Freshfields. The proposed legislation, although it addresses restrictions on disclosure in the Data Protection Act 1998, does not generally exempt the processing of personal data for the purposes of the bill from the provisions set out in the legislation.

The bill has extended the consent regime on suspicious activity reports to as much as 186 days beyond the initial 31 days; enough time, as lawyers have agreed, to kill a corporate deal. The NCA will need to go to court to get an extension, however, and the process is likely to remain unusual. A “superSARs” facility is to be introduced, whereby banks may combine resources to send in a single suspicious activity report, but exactly how they will adjust their systems and controls to do so is unclear.

The introduction of a “failure to prevent” corporate tax offense under the bill’s proposed legislation means banks should be deciding this year whether the financial crime unit or tax department takes control. Ruby Hamid, a financial crime specialist at Freshfields, said the new offense would direct law enforcement’s attention to banks’ systems, and that the

reasonableness of the procedures in place to prevent an offense would be the battleground for any prosecution.

Much of the Criminal Finances Bill has evolved from the larger work of HM Treasury's AML action plan. The plan, with the Fourth Money Laundering Directive (4MLD), aims to enhance the UK's risk-based approach. 4MLD, to be transposed by June 2017, will cost an estimated £341.6 million over 10 years. Some changes made to the directive in the presidency compromise text will have crystallized by early 2017, including greater information-sharing facilities between law enforcement bodies and regulators.

BENEFICIAL OWNERSHIP

4MLD has provided the clearest guidance so far on identification of beneficial owners, which will require the identification of the holders of 25 percent plus one shares, and if this proves impossible, to go to direct or indirect control, including voting rights. As a third step, if it is impossible to identify the natural person who exerts the direct or indirect control, the senior manager may be considered the beneficial owner.

De-risking remains an unresolved issue in financial institutions; perhaps not surprisingly, the FATF has attributed this partly to supervisory penalties and AML compliance costs. According to Wilkes, banks are equally concerned about the knock-on consequences of regulatory penalties, such as the impact on their ability to secure correspondent banking relationships, as well as the risk of U.S. class-action lawsuits.

LIBOR MANIPULATION

From a criminal perspective, the Serious Fraud Office continues its investigations into Libor manipulation, where it has so far brought charges against 13 individuals, and Euribor manipulation, instigated as a result of its Libor enquiries. More deferred prosecution agreements are likely in 2017.

MIFID II PREP, BREXIT TO DOMINATE CONTINENTAL REFORM

On the securities supervision and asset management front, preparation for MiFID II, which will come into effect on January 3, 2018, will dominate the agenda. Already the subject of a one-year extension earlier this year, the amount of change required on the part of market participants and regulators alike will be substantial.

Among other things, MiFID II will introduce stricter rules governing the providers of financial services and issuers of financial instruments, increase transparency requirements, tighten client disclosure requirements and expand the organizational requirements for financial services providers. Some of the provisions have already been transposed into the national laws of European countries.

For example, in Germany, the rules governing fee-based advice have been incorporated into the Fee-Based Investment Advice Act (*Honoraranlageberatungsgesetz*), while the MiFID II rules on defining a target market for financial instruments and BaFin's (*Bundesanstalt für Finanzdienstleistungsaufsicht*) product intervention rights have been implemented in the Retail Investor Protection Act (*Kleinanlegerschutzgesetz*). Other rules will be introduced with the transposition of MiFID II, which means regulators and market participants will still have their work cut out for them.

Similarly, the European Market Infrastructure Regulation (EMIR) will continue to be an area of focus, with the French market regulator in particular flagging EMIR II, which is about enhancing one of the major reforms of the post-crisis regulatory wave, as a core focus for the year ahead.

ACCESS TO THE COMMON MARKET

Access to the common market following Brexit will be a focal point for some regulators. In France, regulators have also



announced they are actively targeting UK financial services companies keen to set up shop on the continent to retain access to EU markets. Both the Autorité de contrôle prudentiel et de résolution (ACPR) and the Autorité des marchés financiers (AMF) have said they will welcome businesses that already conduct activities in France by allowing them to establish companies in France that would be licensed and supervised by the ACPR.

For existing activities that are already supervised by the competent authority in the home country, the licensing procedure may be simplified and expedited. The AMF, meanwhile, is setting up a dedicated welcome program for management firms and fintech companies based in the UK that want to apply for an authorization from the AMF.

Such an approach remains, so far, unique to France, although it is possible that Germany will provide a similar program in the future. BaFin is examining various details and possible Brexit-related implications from a legal and regulatory perspective but said that, for the time being, no similar program had been established.

In the Netherlands, it is business as usual where Brexit is concerned. "As a supervisor, we are not actively soliciting firms to establish themselves in the Netherlands. Our general approach is to be open and transparent, and to engage actively in discussions with firms. We note the efforts by other supervisors in this regard, and feel that our general approach already offers the same kinds of facilities others have dedicated to Brexit," said a spokesman for the Netherlands Authority for the Financial Markets (AFM).

SANCTIONS

Sanctions are also set to become increasingly important across continental Europe. This is driven by regulations such as MAR, which took effect across the EU in July 2016. In Germany, this has meant that the level of fines that can be handed out has increased significantly. For example, while previously the fine for infringements of prohibitions against market manipulation by natural persons was limited to one million euros, BaFin is now empowered to impose fines of up to five million euros.

Legal entities may in the future be subject to fines of up to 15 million euros for deliberate or negligent infringements of prohibitions against insider dealing and market manipulation. BaFin may alternatively impose a fine defined as a percentage of revenues in cases where this would be greater. It may set a fine of up to 15 percent of the total annual turnover of the legal entity according to the last available accounts approved by the management.

BANKING SUPERVISION

On banking supervision, the Basel Committee on Banking Supervision is discussing new rules for risk assessment. While it is unclear what the result of these discussions will be, the outcome will no doubt be significant for European regulators and supervisory authorities.

INSURANCE

Continuing low interest rates means the Solvency II Directive, enacted in 2016, will remain on the radar. In May, insurers will be required to publish their solvency and financial reports, thereby making their capital situation accessible to the public

for the first time. This could have far-reaching consequences for insurers in a number of EU countries. EU member states will also need to transpose the Insurance Distribution Directive, which regulates the activities of all product distributors, into law in February 2018, and so preparations will continue during 2017.

EXPERT VIEWS: WHAT ARE THE FCA'S PRIORITIES IN 2017?

Thomson Reuters Regulatory Intelligence asked a number of industry experts what the FCA's priorities will be in 2017.

Barnabas Reynolds is head of the global financial institutions advisory and financial regulatory group and is global co-head of financial institutions for Shearman & Sterling LLP:

The FCA will continue to prepare for the implementation of much of MiFID II, although it may keep an eye on timing, in the context of Brexit, with a view to deferring the implementation of the most stringent requirements it considers may potentially be harmful for the UK financial services sector. It will also want to ensure that European authorities listen to its views on issues emerging from the review of the European Market Infrastructure Regulation [EMIR] which, unless dealt with effectively, will continue to plague the derivatives markets.

Tackling financial crime is a UK focus now, and the FCA will be under pressure to show that it can deliver on some of its initiatives in this area, such as financial crime reporting and whistle-blowing, as well as contribute sensibly to the fight against cyber crime. Pushing ahead with its proposals to extend the Senior Managers & Certification Regime to other firms is likely to take a front seat once the regulator has had the opportunity to observe the existing – and recently revised – regime in practice.

The FCA should also consider more closely what the UK's regulatory framework will look like post-Brexit so that it has a comprehensive understanding of the improvements it thinks could be made in the UK after Brexit. Both the enhanced equivalence model and the financial center model represent the best legal and regulatory frameworks for a post-Brexit UK. The FCA will want to equip itself to lead on how UK regulation can evolve, while applying international standards and best practices, so that the city maintains its status as a highly attractive financial center.

Chris Warren-Smith, global head of investigations, and Ian Pegram, global head of practice development – investigations at Norton Rose Fulbright LLP:

In its Business Plan for 2016/17, the FCA highlighted a number of areas of focus which will have significant impact on investigations and enforcement, namely culture and behavior, financial crime and AML, technology, and competition.

A clear pillar of the FCA's strategy is that firms will be expected to develop and embed a culture of good behavior, although firms will find it challenging to ascertain the FCA's expectations with precision. Firms found to have fallen short of the FCA's expectations in developing and maintaining compliant culture and behavior may well face significant sanction. An important element of this approach is continued focus on senior management responsibility and individual conduct; the industry should expect to see regulatory and

criminal proceedings against individuals in parallel with enforcement against their firms when issues arise.

The FCA will continue to examine the safeguards which firms have in place to prevent, detect and report money laundering. The FCA has indicated that it will work with firms to create a proportionate strategic response to AML risk, but it will be a challenge for the FCA to deliver on new technologies to make compliance proportionate and efficient.

The fintech sector creates particular areas of risk. The FCA will be looking closely at how fintech sector participants manage cyber risk and more “traditional” financial crime risk, such as AML and fraud.

The FCA will focus on promoting competition in the interests of consumers, both wholesale and retail. As a result, it seems likely that investigations and enforcement will arise out of alleged anticompetitive practices in the financial markets.

Finally, in fighting financial crime, the FCA is expected to continue its close engagement with its domestic counterparts, such as the National Crime Agency, and internationally with the U.S. SEC, as has been seen in recent high-profile investigations.

Formerly a manager in the FCA’s enforcement and financial crime division, Greg Brandman is a partner in the litigation and dispute management team at Eversheds:

In terms of FCA enforcement priorities, market abuse is back at the top of the agenda following a relative lull in activity in this area over the last couple of years.

The FCA’s new director of enforcement, Mark Steward, has been in his role for just over a year now, and the word coming out of the FCA is that his background as a securities regulator in Hong Kong (he was previously executive director of enforcement at the Hong Kong Securities and Futures Commission) is driving his focus on enforcing the UK market abuse regime in particular. Note also the shift in focus evidenced by the renaming of Steward’s division to “Enforcement and Market Oversight.”

This shift in enforcement focus coincides with the entry into force of the EU MAR as of July 2016 (replacing the old regime under the Financial Services and Markets Act 2000). MAR has introduced several new regulatory offenses, including attempting to insider deal and to commit market manipulation, committing market abuse by cancelling/ attempting to cancel orders, and a presumption of market manipulation where orders are placed using an algorithm and there is no intention to trade. This has considerably enhanced the FCA’s regulatory toolkit to deal with market abuse.

On the supervisory side, an important FCA priority for 2017 will be an increasingly intrusive focus on UK firms’ financial crime systems and controls. The quality of such controls in the overseas banking sector in London is perceived by the FCA to be a particular area of concern, and regulators are increasingly challenging senior management’s approach to managing financial crime risk, both from governance and a cultural perspective.

Michael McKee, partner, and Ian Mason, legal director, financial services regulatory team, DLA Piper:

Brexit. UK financial regulation is heavily influenced by, and integrated with, European regulation. Once Article 50 has been triggered, and the terms on which the UK is leaving Europe become clearer, the FCA will need to develop the post-Brexit regulatory landscape. How will the FCA cooperate with EU regulators in the future? Will FCA rules start diverging or track what EU regulators do? This work will extend well beyond 2017.

Fintech and regulatory innovation. This is a rapidly developing area, where the FCA has made a good start with its Project Innovate and regulatory sandbox. The FCA will be keen to strengthen its reputation in this area and help to facilitate the UK’s fintech advantages.

Financial crime. This was identified as a priority in the recent FCA mission statement document. Expect greater use of technology and big data by the FCA to detect insider trading, market manipulation and money laundering, and more enforcement cases.

Senior managers regime. The revamped SMCR was introduced in March 2016. Individual accountabilities should now be clearer, making enforcement action easier to bring against those who fall below the regulatory standards. Proposals to extend the regime to all FCA firms will be published and developed for implementation in 2018.

MiFID II and markets. Implementation of major changes to market infrastructure and capital markets regulation will come through MiFID II implementation in time for a January 2018 deadline.

Competition in financial services. As the recent FCA report on fees charged in asset management shows, the FCA is beginning to use its new competition powers. The FCA and the PRA (Prudential Regulation Authority) also want to encourage new entrants into the financial services industry (challenger banks are an example) and to make it easier for consumers to shop around and move between providers (requiring insurers to show last year’s insurance premium on renewal is another example of this).

Regulatory reform. The FCA has promised to review its handbook of rules and guidance, and Andrew Bailey, as the new CEO, in line with the mission statement, may also want to reset the FCA’s strategy and priorities. This could also lead to organizational and structural changes.

Across North Asia, firms will continue to be affected by new regulatory developments, both from a regional and global perspective. In addition, they will also have to contend with a more uncertain geopolitical climate than in recent years, with political upheavals in the United States and the EU in 2016 setting the scene for a 2017 that will be both challenging and different.

Economies across the region will face new cross-border regulations in the form of the OECD’s (Organisation for Economic Cooperation and Development’s) program for automatic exchange of tax information (AEOI) and moves toward finalizing capital standards under the Basel III regime. At the same time, however, banks face the potential repeal of the Dodd-Frank Act in the United States, which has the potential to undo years of preparation and planning by the financial industry.



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MIDDLE EAST AND AFRICA

GULF REGULATORS TARGET STABILITY, ENHANCE STANDARDS

The strategy of the UAE Central Bank for 2017-2021 includes “major strategic objectives” that focus on its role in ensuring financial stability. Areas of concern include enhancing the supervisory framework for banks and other financial institutions; improving banking operations services; and ensuring safe, sound and efficient clearing and settlement systems within the UAE.

During 2016, draft standards and regulations were issued for consultation on Basel III capital quality phases and risk management regulations, said Luke Ellyard, partner at KPMG. Final guidelines will be issued during the transition period to January 1, 2019.

UAE regulators this year are likely to issue more draft regulations focusing on the detailed elements of Basel III capital requirements, including disclosures, supervisory features and additional requirements for domestic systemically important financial institutions. Other regulations are expected on outsourcing, financial reporting, internal controls, compliance and internal audit.

Increasing diversification of the Gulf Cooperation Council (GCC) economies has made them more attractive to investors, said Sally Sfeir-Tait, partner at Clyde and Co in Dubai. “We have already seen [the] emergence [of] legislation aimed at modernizing the existing legal infrastructure and at making

[member] countries more attractive to investors. In the UAE, the issuance of the bankruptcy law is a notable new development.”

This year is likely to see more stringent regulatory expectations and scrutiny, particularly from the Dubai Financial Services Authority, which oversees regulation of the free zone, and the Central Bank, said Ahmed Kalo, compliance and AML manager at Rasmala Investment Bank. “Advanced compliance training and practice will . . . follow to keep pace with further developments in rules and regulation.”

Oversight of anti-money laundering and counter-terrorism financing (AML/CTF) procedures remains sensitive, with Gulf governments and regulators mindful of the delicate position in which they find themselves.

“The UAE’s geographical position, in close proximity to sanctioned countries, and its traditional trading activities and thereby transactions with these countries, can potentially put a strain on local banks’ relationships with regulators and international banks, as the continuous changes to global sanctions requirements pose ongoing challenges to banks in the region,” Ellyard said.

“[T]hey need to ensure their sanctions and payment screening systems are kept constantly up to date. In the highly competitive market that they are in, they cannot afford the loss of correspondent banking relationships due to compliance failures.”

"The region also faces the additional challenge of a very high level of money service businesses and cash transactions; both are regarded by international regulations as high-risk areas."

Luke Ellyard

KPMG

Effective KYC policies and control frameworks are now essential in discharging the growing number of legal and regulatory obligations designed to prevent identity theft, financial fraud, money laundering and terrorist financing.

The enactment of the new UAE federal AML/CTF law in 2014, and a separate federal law to combat terrorism crimes issued the same year, brought the UAE AML/CTF legal framework into closer alignment with international standards. It also expanded the enforcement powers of the regulator to impose administrative sanctions and restrict the powers of senior management.

"The region also faces the additional challenge of a very high level of money service businesses and cash transactions; both are regarded by international regulations as high-risk areas," Ellyard said.

Financial center Abu Dhabi Global Market has encouraged a number of fintech incubators with its "sandbox" regulatory regime for testing innovative products, which launched in 2015 with a two-year viability window.

"With regard to next-generation payment services, or providers who offer bitcoin or other virtual currency payment services, these firms are already under heavy scrutiny not only from regulators but also from banks who, in the majority of cases, still do not provide them with access and the ability to receive fiat currencies and convert them into virtual currencies," Sfeir-Tait said.

DE-RISKING

De-risking in international banking has proved acutely problematic for banks and financial institutions that provide international wire transfers, trade finance, cash management services, check clearing and settlement.

"GCC banks have enhanced standard compliance as part of a de-risking strategy by limiting or completely cutting off correspondent services to simplify monitoring of payment flows to effectively minimize or eliminate potential risks," Kalo said.

A delicate balance was needed between adopting effective practices while implementing reforms in a way that was sensitive to local market dynamics and met the objective of continued economic growth, Ellyard said.

"The UAE has witnessed the impact of the ever [more] restrictive requirements of the global regulatory agenda as certain international banks have reassessed their activities in the UAE market to varying degrees," he said.

FOUR THINGS TO WATCH IN AFRICA IN 2017

The mention of money laundering regulation in Africa can provoke derision elsewhere, but that masks the full story of the progress many countries have made. Among the challenges in 2017 for African AML professionals will be the focus by international regulators on politically exposed persons (PEPs) and customer due diligence.

Many expected President Jacob Zuma of South Africa to have signed the Financial Intelligence Centre Act, but he delayed the bill, arguing that its focus on warrantless searches was unconstitutional. More banks are likely to be fined regarding their scrutiny of PEPs and their screening of customers, sources said.

The FATF removed Kenya from the watch list of countries with major AML deficiencies in 2014, but its banking system faced plenty of turmoil in 2016. The industry is undergoing consolidation after several banks collapsed in 2016. The Kenyan Central Bank has strengthened capital requirements, and observers expect weaker banks to fail or be acquired by stronger rivals in 2017.

Nigeria, the continent's largest economy, has long held a reputation as a money laundering haven, but the FATF has recently commended its crime-fighting efforts. The FATF removed Nigeria from its blacklist in 2013, but all eyes will be on the country's mutual evaluation in early 2017. A major focus of this health check will be how well Nigeria's banks screen their customer accounts for potential AML violations.

With Nigeria also introducing foreign exchange controls to prop up its currency, banks involved in correspondent banking could be in the firing line. Companies such as airlines are likely to avoid doing business with them because of the complexity of conducting international transactions. "If companies cannot get money out, banks will take a hit on correspondent transactions," one source said.



President Jacob Zuma of South Africa

Reuters/Nikhil Monteiro

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ASIA-PACIFIC

MARKET MISCONDUCT AND AML TO BE TOP SINGAPORE CONCERNS

An eventful 2016 in Singapore, which included the closing of two private banks and massive fines imposed on a few large domestic and foreign financial institutions embroiled in the fund flows related to Malaysia's troubled sovereign fund, 1 Malaysia Development Berhad (1MDB), has turned the Monetary Authority of Singapore (MAS) into the most watched regulator in the region.

The withdrawal of two banking licenses in less than three months in 2016 was unprecedented, although not the first time in Singapore's banking history that MAS had ordered a bank closure.

MAS will be steadfast in its focus on AML concerns both domestically and on a cross-border basis in 2017. The new AML and enforcement departments set up by the regulator in August 2016 are expected to start some serious work in the new year.

MARKET MISCONDUCT

Market misconduct and AML are expected to top MAS's enforcement priorities this year, said Joanna Pearson, partner at Simmons & Simmons JWS in Singapore.

However, unlike other jurisdictions, there is little sense of a shift toward holding individual executives accountable for violations at firms.

"There were plenty of statements [by the MAS] around market misconduct in 2016. The two enforcement priorities – market misconduct and AML – are MAS's current priorities, and they

will continue [to be so], but I don't particularly see that as increasingly targeting individuals rather than the institutions themselves," she said.

Market misconduct will be pursued against individuals largely because offenses such as insider trading and market manipulation involve individual actions. However, unlike UK and U.S. regulators, who have made clear their intent to target individuals for market misconduct offenses, MAS has made no such declaration of a shift in strategy.

The prosecution of six former employees of BSI Bank and a former country manager at Falcon Private Bank was a move considered rare by local standards. That has led to speculation about whether MAS will increasingly hold individuals to account and whether it intends to introduce some kind of senior management regime, but Pearson discounted that idea.

"The BSI case is very much about individual acts or omissions. I don't think it suggests it's about senior management accountability without involvement in the underlying facts. The concept of senior management responsibility is a little different to me than the recent enforcement actions against an individual, which were a result of their own misconduct," Pearson said.

Nonetheless, MAS has begun to focus more on corporations and financial institutions, following the introduction of regulations for corporate derivative liability, said Nizam Ismail, head of regulatory practice at RHTLaw Taylor Wessing in Singapore.

For instance, a rogue dealer involved in market-rigging from which the firm is found to have benefited, and colluded with, could result in the firm itself being held liable.

The liability risk for the firm, Nizam said, lay in individuals, including senior managers, who were involved in or who condoned practices such as facilitating money laundering, as seen in the cases involving BSI Bank and Falcon.

Other potential repercussions following the 1MDB-related probe may see MAS amend the mandatory Code of Conduct for licensed individuals, as well as more background checks on licensed individuals when they move from one bank to the next, said Daniel Chia, director at Morgan Lewis Stamford in Singapore.

SINGAPORE'S VERY OWN SENIOR MANAGERS REGIME?

The tough enforcement actions taken against former employees of BSI Bank and Falcon are unlikely to pave the way for a senior managers regime in Singapore in the near future. The UK's regime, implemented two years ago, is a significant undertaking and followed a period of intensive enforcement activity.

"The senior managers regime in the UK reflects frustration at the lack of change of culture. It's about driving cultural change and responsibility by making sure senior management is accountable for their team as a whole. Simply imposing fines and enforcement action is one way of dealing with the issue. I would think that other regulators would want to see how it is working in the UK before implementing a similar regime. It would be quite early days to do this in Singapore," Pearson said.

MAS set up its enforcement department just six months ago and is seen as having just begun to toughen up on disciplinary actions. The regulator is likely to wait until it has bedded down its existing regime before introducing a senior management regime.

"You have to put the UK senior managers regime in the context of the UK's enforcement activity in the last nine years after the financial crisis," Pearson said.

"The senior managers regime in the UK reflects frustration at the lack of change of culture. It's about driving cultural change and responsibility by making sure senior management is accountable for their team as a whole. Simply imposing fines and enforcement action is one way of dealing with the issue. I would think that other regulators would want to see how it is working in the UK before implementing a similar regime."

Joanna Pearson

Simmons & Simmons JWS

AML EFFORTS

This year should be a year of consolidation, supervision and enhanced surveillance of MAS's AML efforts. With all the AML law, regulations and guidelines in place, backed by the newly established AML and enforcement departments, MAS is not expected to introduce further amendments this year. Ravi Menon, managing director of MAS, made that clear in a speech last year, saying enforcement would instead be a priority. The exception is likely to be Notice 626, which MAS is expected to amend.

"I don't expect to see an increase in AML legislation. The current CDSA [Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act] is wide enough to cover a lot of areas. There may be further clarifications and notifications, guidelines, etc., but the core AML legislation is very robust and wide-ranging," Chia said.

Singapore will address criticism contained in the FATF mutual evaluation report as it seeks to implement the recommendations. There will be a stronger focus on cross-border money laundering activity, an area where the FATF deemed Singapore to have fallen short. There will also be more AML enforcement, asset forfeiture and terrorist financing prosecution, Nizam said.

Market sources said financial institutions that had been inspected, particularly those ensnared in the fund flows for 1MDB, might encounter repeated inspections this year. Financial institutions can expect MAS's new AML team to turn up for repeated inspections as it seeks to ensure failures previously unidentified are now addressed properly and controls strengthened accordingly. Any lapses or breaches could result in enforcement actions being taken against them.

MAS is expected to work closely with financial institutions as it seeks to strike a balance between going for big enforcement headlines and ensuring institutions have proper AML controls in place.

This year may see MAS revisit its plan to regulate AML activities related to cryptocurrency such as bitcoin, following an announcement in 2014. MAS has said that although cryptocurrency players will not be licensed, it will require them to comply with the AML regulations. The market widely expects MAS to draw up standards during 2017.

TRADING BOOK REFORMS ON TRACK, FULL BASEL IMPLEMENTATION STILL THREE YEARS AWAY

Even with full implementation of Basel III still three years away, a new package of capital standards has acquired the market nickname "Basel IV." These requirements stem from the Fundamental Review of the Trading Book (FRTB), leverage ratios, and the various refinements to market risk, credit risk and operational risk frameworks.

Essentially, Basel IV seeks to achieve a number of objectives, including the introduction of conservatism and stability into the banking system, reduction of volatility in risk-weighted assets, and the provision of details and guidelines on the rules and model calibration. The initiative has also raised questions about more capital requirements.

Banks are concerned about the Basel Committee on Banking Supervision's proposals to increase capital further. These proposals include the risk-based model for credit risk, the full

impact of the changes to market risk under the FRTB requirements, the standardized measurement approach to operational risk and the final implementation of the net stable funding ratio.

The FRTB has three main objectives: to eliminate capital arbitrage between the trading and banking books by reducing the transfer of risk between them, to make the standardized model of market risk calculation a credible alternative to the internal risk-based (IRB) model approach, and to address existing weaknesses of the IRB approach.

The FRTB has posed a number of challenges, such as defining the individual trading desk, implementing profit and loss attribution at the individual trading desk as a performance metric and providing the amount of data banks need to capture. These challenges are expected to continue in 2017, said Kishore Ramakrishnan, director of consulting at PwC in Hong Kong.

In 2016, banks began initiating desk-level pilot analyses to ascertain the impact of FRTB across the front- and back-office functions, Ramakrishnan said. This involved picking out a few samples of trading desk risk and subjecting them to the standardized approach or the internal model approach to determine the capital charges and identify compliance gaps in their processes, systems and infrastructures. Such work would continue, Ramakrishnan said.

CONCERNS ABOUT THE FINITE LEVEL OF CAPITAL

Banks using the IRB model approach will need to rebuild the standardized model equivalent to work out the capital floors. This will involve a degree of heavy computation and data work to secure the appropriate data set and modeling techniques.

"All this is about people's concerns on the finite level of capital. What does that mean for the business? Is there a need to revisit the business? Banks are going to run the calculation under FRTB, and they are going to work out whether it makes sense to stay in the business," said Keith Pogson, a senior partner at EY in Hong Kong.

The G20 and the various forums will continue to push bank regulators in most important markets to adopt these new standards, and regulators in the major jurisdictions will be under pressure to adopt them, Pogson said.

The biggest concern about Basel IV will revolve around the capital floors, the multiplier percentages that drive the floors and what they mean for the business.

"There will be further lobbying around this topic – more quantitative evaluations and trials. Banks will do more lobbying if they find certain parts of Basel IV demanding," he said.

FRTB IN ASIA

The Basel Committee issued the final FRTB standards in January 2016. The first reporting obligation will start in December 2018, with full implementation of FRTB in January 2019. Some Asian regulators have hinted that they might release a consultation paper on FRTB in the first or second quarter of 2017.

The potential impact of FRTB on a country's economy will determine whether national regulators will fully adopt the proposed requirements from the Basel Committee, Pogson said. Some of the requirements, for instance, may discourage foreign banks from lending to the middle-market credits and the small

business sector because they will be less competitive compared with the domestic banks.

In Asia, where the less developed jurisdictions remain at Basel II, while others have yet to fully implement Basel III, it is likely that only the leading financial centers such as Hong Kong and Singapore will aim to adopt FRTB.

The industry will want to see more certainty from the Basel Committee as to whether there will be new regulations following Basel III. Asian regulators and banks alike will want more clarity about where the new capital requirements will end.

COORDINATED IMPLEMENTATION OF MARGIN RULES EXPECTED IN ASIA

Margin requirements for non-centrally cleared derivatives dominated the headlines in Asia last year as market participants prepared for implementation of the requirements on September 1, 2016. An unexpected turn of events, however, largely the result of European regulators pushing back their plans to implement the margin rules on the date recommended by the Basel Committee on Banking Supervision, upset the implementation timetables for most regulators in Asia, with the exception of Japan.

Japan, Canada and the United States were the only three jurisdictions that had committed to implementing the margin rules for uncleared derivatives on September 1, 2016.

ASIAN REGULATORS TO IMPLEMENT MARGIN RULES IN MARCH

In a coordinated effort, the Australian Prudential Regulation Authority (APRA), the Hong Kong Monetary Authority (HKMA), and the MAS announced simultaneously in December that they would implement the final rules for both initial and variation margin (VM) for non-centrally cleared derivatives in their respective jurisdictions on March 1, 2017. This eliminates the uncertainty and effectively gives market participants nine months to comply with the new rules. The three regulators will allow the industry a six-month transition period to comply with the full set of margin rules.

This year will see financial institutions in Asia intensify their efforts to complete preparation for the margin rules to take effect in March. These include sorting out the legal documents; making operational infrastructure changes; and ensuring they



can meet the strict requirements on the type of collateral that can be posted, that there is sufficient liquidity for collateral, and that they are able to meet the required timing for settlement.

VM will be an industry-wide concern because of its impact on all financial and nonfinancial counterparties. Financial counterparties such as asset managers, insurance companies, pension funds and hedge funds will be caught by the margin rules, as will corporations that trade significant volumes of derivatives with banks. It remains to be seen whether these entities have the necessary processes and systems in place to comply with the margin rules.

European supervisory authorities have announced that they will implement the margin rules in January 2017, thus alleviating the uncertainty for market participants; speculation is rife as to whether the U.S. presidential administration of Donald Trump may delay the phase two and three implementation of the margin requirements, which could have an impact on Asia.

The Basel Committee has recommended a phased implementation for initial margin requirements over a five-year period from September 1, 2016 to 2020.

EXTRATERRITORIAL EFFECTS OF NEW U.S.-PERSON DEFINITIONS

The extraterritorial effects of the U.S. Dodd-Frank Act will once again be felt if proposed U.S.-person definitions issued by the CFTC in October 2016 are adopted. The definitions will have implications for nearly all the regulations under Dodd-Frank, including margin rules for non-centrally cleared derivatives and the Volcker Rule.

The new U.S.-person definitions, if adopted, will also apply to all subsequent rulemaking that seeks to address the cross-border applications of Dodd-Frank, said Ramakrishnan. "That is the most important takeaway of the proposed definitions of U.S. persons," he said.

The CFTC's proposed definitions of U.S. persons have elicited a strong response, as expected. On behalf of its member regulators, Ryozi Himino, chair of the International Organization of Securities Commissions' (IOSCO) Asia-Pacific Regional Committee, wrote to the CFTC on December 19, expressing a number of concerns. The International Swaps and Derivatives Association has also made representations.

The IOSCO Asia-Pacific committee questioned the limited benefits of the CFTC's expanded extraterritorial rule and the unusually high costs to which non-U.S. persons transacting with U.S. persons would be subject. It said most other non-U.S. persons in Asia which entered transactions with U.S. persons or foreign consolidated subsidiaries of U.S. entities did so solely for hedging purposes to reduce risks in their core banking business and so were unlikely to have a direct and significant impact on the U.S. economy.

The committee pointed out the need for a clear outcome-based substituted compliance framework and asked the CFTC to give sufficient time for conducting substituted compliance determinations for Asian jurisdictions.

The arrange, negotiate and execute (ANE) test is one of the important features under the new definitions of U.S. person, particularly for swaps which are booked by a U.S. bank outside the United States but arranged and negotiated or executed by staff in its U.S.-based branch. ANE will determine where a U.S.

bank does its swap business and where the people doing the swap business will be located.

A U.S. bank is likely to want staff doing the swap business to be based outside the United States so it can circumvent the regulation, said Craig Hickernell, partner at Seward & Kissel LLP in New York.

The CFTC was concerned a U.S. bank might be doing a swap in a location outside the United States and signing the swap in the name of one of its foreign branches, while the people arranging, negotiating and executing were in the United States, Hickernell said. The CFTC wanted to ensure it continued to regulate the foreign branches of U.S. banks because they are considered part of the U.S. swaps market. U.S. banks that arrange, negotiate and execute a swap will not derive any regulatory benefit from booking trades outside the United States.

NORTH ASIA NATIONS CONFRONT UNIQUE DOMESTIC CHALLENGES

North Asian countries face unique challenges in 2017. In Japan, the Financial Services Agency has signaled a change in its supervisory approach toward banks, from a rules-based minimum standards regime to one based more on codes and principles.

Nobuchika Mori, the FSA commissioner, has previously voiced concerns about excessive regulation after the financial crisis. He said recently the FSA would introduce a unique and forward-looking supervisory approach under which Japan's banks would be subject to "tailor-made supervision," thus pushing each bank to do its part to revitalize Japan's economy.



Shinzō Abe, Japan's prime minister

Reuters/Agustin Marcarian

Japan is also improving corporate governance, having introduced both a stewardship code for institutional investors and a corporate governance code in recent years. Accounting scandals at Toshiba and Olympus have put the spotlight on the risks posed by a conservative corporate culture that serves the interests of executives above those of shareholders. The impetus for reform has come from Prime Minister Shinzō Abe, as he seeks to encourage foreign investment ahead of the Tokyo Olympics in 2020. The country has been climbing steadily in international corporate governance rankings, but much remains to be done.

SOUTH KOREA

Across the Sea of Japan, South Korea is modernizing its financial sector, with the Financial Services Commission (FSC) spearheading a technological innovation program that has gone largely unnoticed elsewhere. In a sweeping reform initiative, the regulator has been abolishing what it calls “quasi-regulations” – excessive regulatory guidance that was often given verbally by the regulator in the past and that has long been seen as a burden.

The FSC is also working with foreign financial firms as part of its reform drive, with the aim of attracting further foreign investment. The country is introducing a stewardship code similar to Japan’s, using a “comply-or-explain” approach.

CHINA

In China, macroeconomic issues dominate amid concerns about the well-being of its banking sector and the level of nonperforming loans, a devaluing currency and increasing capital outflows. Loans to the property sector and provincial governments are also looking shaky, with unregulated wealth management products, which underpin many property construction projects, now accounting for almost one-fifth of system deposits, according to recent figures.

HONG KONG

The Special Administrative Region faces a year of even more uncertainty than 2016. Political upheaval and interference from Beijing have weakened international trust in the territory’s rule of law and its future as a gateway to China. Last year saw a growing tendency for Chinese firms to bypass Hong Kong for foreign merger and acquisition deals. Rules introduced to stem the capital outflow from China in November are likely to limit still further the funds fueling the financial sector.

However, Hong Kong’s approach to policing markets is expected to be invigorated following the appointment of Thomas Atkinson as the Securities and Futures Commission’s (SFC) new executive director of enforcement. Atkinson has promised a narrower focus on high-priority and high-impact cases, particularly with regard to corporate fraud and malfeasance. The SFC will also work closely with the China Securities Regulatory Commission to monitor trades on the two cross-border Stock Connect programs with Shenzhen and Shanghai.

Announcements by UBS and Standard Chartered in late 2016 indicated they were under investigation by the SFC for their roles as sponsors of mainland Chinese companies listed on the Stock Exchange of Hong Kong, something that, since 2013, has been seen as intentional malfeasance and carried criminal consequences.

The SFC wants more say regarding which companies are allowed to list in Hong Kong and what share structures they are allowed to use. A contested consultation paper issued by the regulator and the stock exchange has highlighted what some have termed a “turf war” between commercial interests at the exchange on one side and regulatory concerns at the SFC on the other.

Hong Kong signed a mutual recognition framework for funds with China in 2015, and more recently with Switzerland in late 2016, as it seeks to attract more asset management business. As part of this approach, it has recently launched a consultation

on changes to its Fund Manager Code of Conduct, with implementation planned for late 2017.

FATF VISIT LOOMING

The AML unit of the HKMA is likely to have a busy year, as it gears up for a much-anticipated mutual evaluation of the territory’s AML regime by the FATF in 2018.

The last mutual evaluation was in 2007, and Hong Kong has since made significant strides. These have been visible through the enactment of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance Cap 615 (AMLO) of 2012 and its associated guidelines.

Hong Kong’s regulatory structure should stand up well under FATF scrutiny. The level of enforcement under the AMLO and the record of just one enforcement action by the HKMA, and none by the SFC, may raise some questions, however.

The Panama Papers leaks pointed to Hong Kong being at the center of an international scheme of offshore wealth management that included the management of both legitimate and illegitimate funds. This cast Hong Kong in a poor light.

Similarly, the delayed rollout of legislation mandating the declaration or disclosure of cash and bearer instruments at the border, something for which Hong Kong was given a non-compliant rating previously, will be another blot.

DANGERS BUILDING IN DE-RISKING APPROACH

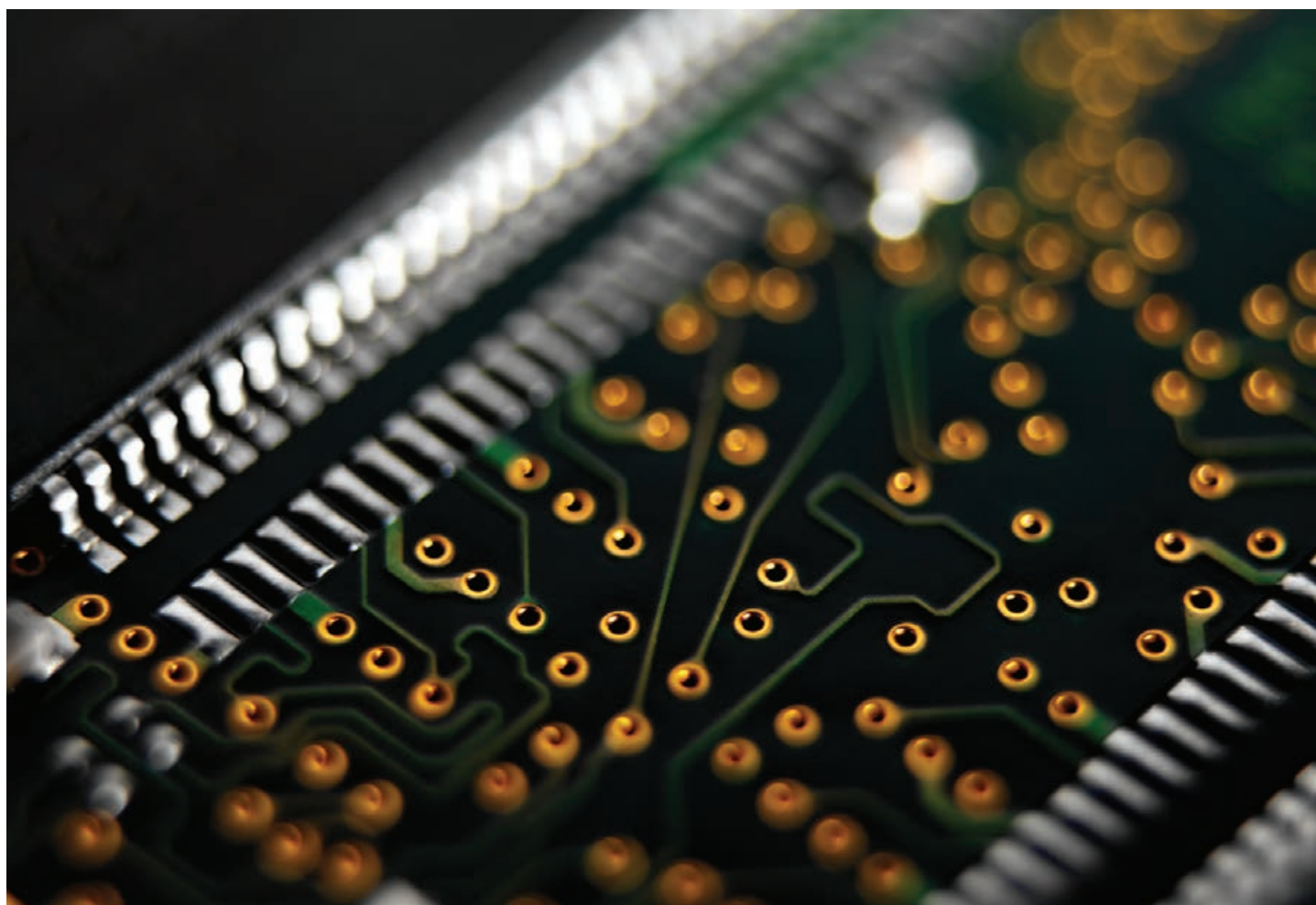
The high volume of AML and KYC enforcement by U.S., UK and EU regulators has led banks to “de-risk”: to cease doing business with clients they regard as high-risk, such as the jewelry and precious gemstones fields, trade-based finance or those from blacklisted countries or with suspicious names and contacts. This has led to more and more individuals and companies joining the legions of the unbanked worldwide, notably in Asia.

The banking sector’s fear of these regulatory sanctions has led Hong Kong banks to de-risk and adopt disproportionate KYC measures. Worse still, de-risking may force more legitimate businesses and people to move into the banking shadows. De-risking has presented a challenge for ordinary customers and more sophisticated market participants alike, said Paul Dorrans, a registered foreign lawyer with Simmons & Simmons.

The rationale for such actions was often unjustified, said Bill Majcher, chief executive of EMIDR, a local cyber security company. “De-risking is creating more risk to the overall system and does nothing to remove other forms of risk from the system.”

“De-risking is creating more risk to the overall system and does nothing to remove other forms of risk from the system.”

Bill Majcher
EMIDR



ASIAN JURISDICTIONS AIM TO BECOME REGIONAL FINTECH HUBS

The concept of financial technology, or fintech, has been firmly entrenched in the financial sector and the agenda of regulators. From what was only, a few years ago, a relatively vague concept have now sprung more defined and specialized branches of technological innovation, often driven by financial institutions' desire to find better solutions for regulatory challenges and business opportunities. Narrower definitions, such as "regtech," "insurtech" and "edtech" have emerged, driving interest to new heights.

The traditional financial hubs of Hong Kong and Singapore have both signaled plans to become regional fintech hubs, although the fintech industries in those jurisdictions are far smaller than those in London and New York. Regulators in both Asian jurisdictions have established fintech contact points, and the MAS and the HKMA have also launched supervisory "sandboxes" for testing new forms of technology in a safe environment.

Despite all the interest, doubts remain as to whether the well-established legal and regulatory regimes in either jurisdiction would be well-suited to accommodate the "disruptive" impact that fintech developers often envision.

South Korea has done more than most jurisdictions, working in the background, where the FSC has been spearheading a rapid technological revolution in the financial services industry for more than a year. Hong Kong's SFC said last year it was studying how the South Koreans had implemented a

Web-based mutual fund supermarket that drove distribution costs down by two-thirds. South Korea is also about to see the launch of several Internet-only banks, and will be one of the first in Asia to do so. In addition, the country has recently abolished many regulations in an attempt to encourage innovation. Yim Jong-Yong, the FSC chairman, is confident such reforms could easily become tomorrow's "international gold standard."

Mainland China is also regarded as more advanced than Singapore and Hong Kong in terms of fintech, because of its lack of regulation.

So far, most attention has been on distributed ledger technology, also known as blockchain, which promises to reduce banks' costs in several areas, including KYC.

REGTECH

Regulators are keen to see more technology adoption in compliance, with automation, machine learning and artificial intelligence (AI) advances likely to cut through cumbersome and paper-intensive reporting processes. Colloquially known as "regtech," a growing number of solutions have emerged, and look set to reduce costs, compliance headcount and reporting time.

James Lau, the acting secretary for Financial Services and the Treasury in Hong Kong, said in November that banks were examining biometric technology and AI solutions that could go far beyond data collection, tabulation and basic analytics, helping banks manage unstructured data and strengthen

surveillance and risk detection. This could help improve both trade surveillance and customer onboarding, he said.

While fintech and regtech are interrelated, both conceptually and in application, their origins differ. Regtech evolved from post-crisis regulatory changes and fintech trends, and extends beyond finance to any regulated sector. Fintech, on the other hand, is more about improving the technology of the original financial system. Jack Ma, the founder of Alibaba, said an important component was to solve the problem of a lack of inclusiveness, particularly in emerging economies, where a relatively large number of people remain unbanked.

In China, services such as Alipay and WeChat have in recent years become highly popular payment systems, although neither is operated by financial companies. Similarly, mobile telephone banking has become the norm in parts of Africa and Asia, allowing telecommunications providers to adopt a role that would otherwise have been played by banks. Invariably, telecommunications and other nonfinancial fintech providers will have to abide by financial regulations if they provide such services, but it is unclear what form such oversight will take and whether it will entail a major overhaul.

AUSTRALIAN REGULATORS TO FOCUS ON RISK CULTURE

“Risk culture” is expected to become a key part of the regulatory lexicon, not just for banks but for all financial services licensees. Bank regulators have already indicated they intend to step back from strengthening capital, liquidity and risk controls within financial institutions and will look more closely at the less tangible aspects of risk culture.

Regulators want to see an improvement in “risk culture,” notably in the life insurance and mortgage lending markets. Risk culture is defined as the influence of organizational culture on how risks are managed in a financial institution.

APRA has focused on the core elements of the Basel reform process in the eight years since the financial crisis. In the year ahead, APRA’s supervisory work will target how people behave within those structures and controls.

“Risk culture” is a relatively new concept. The prudential regulator, for example, has only been collecting and analyzing information on risk culture since late 2015.

APRA has taken the view that chief executives and the boards of financial services firms need to take responsibility for setting the risk culture across their organizations. They need to establish an appropriate culture that allows the institution to operate in line with its strategy and risk appetite.

The Australian Securities and Investments Commission (ASIC), meanwhile, will focus on the connection between conduct risk and risk culture. Conduct risk is one aspect of risk culture that cuts across regulatory jurisdictions. ASIC is expected to focus on “tone from the top,” the dissemination of ethics and values across an organization, business practices, board accountability, staff incentives and governance controls.

ASIC is concerned that, in addition to inappropriate financial incentives, poor culture is one of the main causes of bad conduct within the financial sector.

Although regulators such as APRA and ASIC cannot “regulate good culture into existence,” in the year ahead, they will



ramp up pressure on boards and senior managers if their organizational standards fall short of expectations.

The regulators will also use their supervisory tools to encourage boards to take risk culture more seriously. If the regulators believe a financial institution's culture is unhealthy or misaligned with the organization's strategy and risk appetite, then they will allocate more supervisory attention to those areas.

The main message for boards and senior managers in 2017 is to invest the necessary time and resources into ensuring they have an appropriate risk culture framework in place.

ANTI-MONEY LAUNDERING REGIMES IN TRANSITION

The AML/CTF regimes on both sides of the Tasman will experience significant change throughout 2017 and beyond.

The Australian AML regulator has outlined its broad plans to simplify the AML/CTF Rules for more than 14,000 reporting entities in the year ahead. The Australian government has also begun consulting on its long-awaited plans to include lawyers, accountants, trust and company service providers, real estate agents and jewelers within the AML/CTF regime. Those reforms are expected to take place over a period of years with an implementation target of 2019.

In New Zealand, meanwhile, the government has expedited the second phase of its AML/CTF laws, which are set to be passed in the first half of 2017. "Phase II" will see lawyers, accountants, real estate agents, conveyancers, certain high-value goods dealers and gambling-service providers brought within the regime as reporting entities.

The two countries have taken divergent paths on AML/CTF regulation for so-called designated nonfinancial businesses and professions. New Zealand is focusing on rapid implementation, while Australia, which has been promising reforms for a decade, has emphasized the need for adequate consultation and a considered regulatory response.

The New Zealand government accelerated its plans for a second phase of the AML/CTF regime following concerns that the country had become a target for illicit funds. In response to the Panama Papers and the recent Shewan Inquiry, the government aims to have passed the necessary legislation before the next election.

Last year, the Australian government released the Report on the Statutory Review of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 and Associated Rules and Regulations. The report contained 84 recommendations to "streamline and strengthen" Australia's AML/CTF framework. The Australian Transaction Reports and Analysis Center (AUSTRAC) said it would undertake a staged approach to implementing the recommendations from the review. In 2017, it will undertake a deregulatory program to simplify the compliance obligations for reporting entities.

The proposed rule changes cover customer due diligence and AML/CTF programs. They will include alternatives to the existing minimum KYC requirements for individuals, "safe harbor" and simplified verification procedures, expanding the simplified due diligence regime to cover low-risk entities, allowing self-attestation to identify customers in certain circumstances, allowing entities to accept certified disclosure certificates, and expanding the ability of entities to use third-party customer IDs under certain conditions.

With regard to AML/CTF programs, the statutory review said there was a need to incorporate AUSTRAC information on high risks, clarify the role of a compliance officer, guarantee the independence of an AML/CTF program reviewer and require reporting entities to manage the money laundering and terrorism finance risks posed by new technology.

BRIBERY AND CORRUPTION COMPLIANCE IN THE SPOTLIGHT

Australian authorities are also set to increase anti-bribery and anti-corruption enforcement in response to a series of damaging scandals involving high-profile companies. International agencies have accused Australia of lagging behind in its obligations to tackle corruption, both domestically and internationally. The crackdown follows alleged bribery incidents involving Rio Tinto, BHP Billiton, Tabcorp, Leighton Holdings (since renamed CIMIC), Sundance Resources and the Snowy Mountains Engineering Company.

The federal government has given the Australian Federal Police (AFP) an additional A\$15 million in funding over three years to investigate serious and complex fraud, foreign bribery and corruption. The AFP is also setting up a series of state-based fraud and anti-corruption investigation teams to target these offenses. The first three units will be based in Sydney, Melbourne and Perth. The government will also review the broader legislative framework to ensure investigators have the tools they need.

The federal government is expected to support the introduction of U.S.-style deferred prosecution agreements. The new legislative powers would give prosecutors the ability to strike voluntary, negotiated settlements with organizations in cases of serious corporate misconduct.

REGULATORS TO FOCUS ON BENCHMARK INTEGRITY

The government will push ahead with reforms to strengthen financial benchmarks, such as the Australian Bank Bill Swap Rate (BBSW). Administrators of systemically important benchmarks, such as BBSW, will be required to hold a new "benchmark administration" license issued by ASIC. The regulator will develop rules for the administrators of significant benchmarks and for entities that make submissions to such benchmarks.



ASIC will also have the power to compel submissions to benchmarks in instances where other calculation mechanisms fail. The manipulation of any financial benchmark or financial product used to determine a financial benchmark in Australia will be made a specific criminal and civil offense.

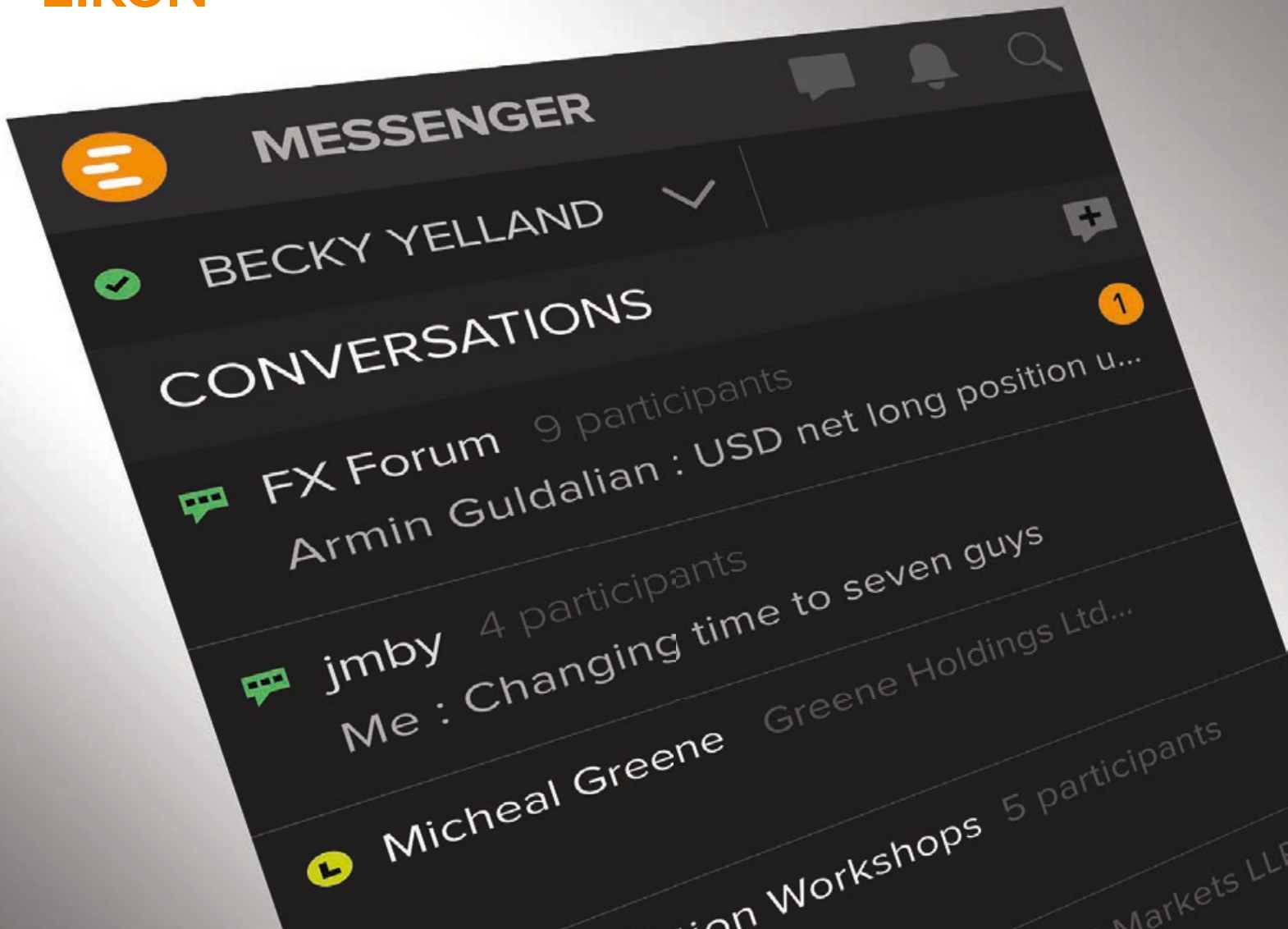
The G20's Financial Stability Board has advocated a move internationally from credit-based benchmark rates, including BBSW and Libor, to make greater use of risk-free rates. Locally, the new BBSW will use a "risk-free" benchmark based on the interbank overnight cash rate.

In line with these reforms, the Australian Securities Exchange (ASX) will take over as the administrator of the main interest rate benchmark from January 2017. The switch follows the Australian Financial Markets Association's decision to distance itself from the benchmarking process. Regulators internationally have been reforming rate-setting practices after Barclays, UBS, Royal Bank of Scotland and others were fined billions of dollars for benchmark rigging.

ASIC will also focus on improving the integrity of benchmarks in 2017. The regulator is embroiled in civil litigation against three of the "four pillars" of the banking industry for alleged manipulation of the BBSW. The cases are expected to proceed to trial this year, with all three defendants indicating they have no intention to settle.

ASIC will argue ANZ Banking Group, Westpac and National Australia Bank traded prime bank bills with the intention of manipulating the underlying market that was used to set the BBSW. The regulator said this market misconduct would have disadvantaged "parties to certain products who had an opposite exposure to the BBSW."

The specific offenses covered in ASIC's claims include unconscionable conduct and market manipulation. The BBSW matter is one of ASIC's longest-running investigations. The regulator has previously secured enforceable undertakings from UBS, BNP Paribas and RBS in relation to BBSW rigging. The banks have collectively paid A\$3.6 million to finance financial literacy projects as part of their settlement.



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