More Than You Ever Wanted To Know About Regulatory Sanctions

Lessons from the Past

Regulatory Update
May 2015

axxsys

Periodically we publish an update on regulatory developments we feel are of interest to our clients. The purpose is partly to keep people up to date and to help them adjust their regulatory efforts according to current events. We also wish to promote our regulatory consultancy services.

This issue will take a closer look at FCA's position on transaction reporting inspired by recent news of the FCA fining a large financial institution for breaches of reporting obligations under MiFID, see [FCA] for details. It is the 12th firm regulated by the FCA to face fines in relation to the MiFID transaction reporting obligation. What makes this case particular interesting is that the base fine used to calculate the financial penalty has been significantly increased compared to previous cases. It is also interesting that a large number of the inaccurate/missing transactions had been self-identified by the firm in question who subsequently informed the FCA about the breaches. It would be natural to expect this to be mitigating circumstances and yet the fine is "significant" compared to previous cases. A comparison of the penalties in the 12 cases can be found in Figure 1.

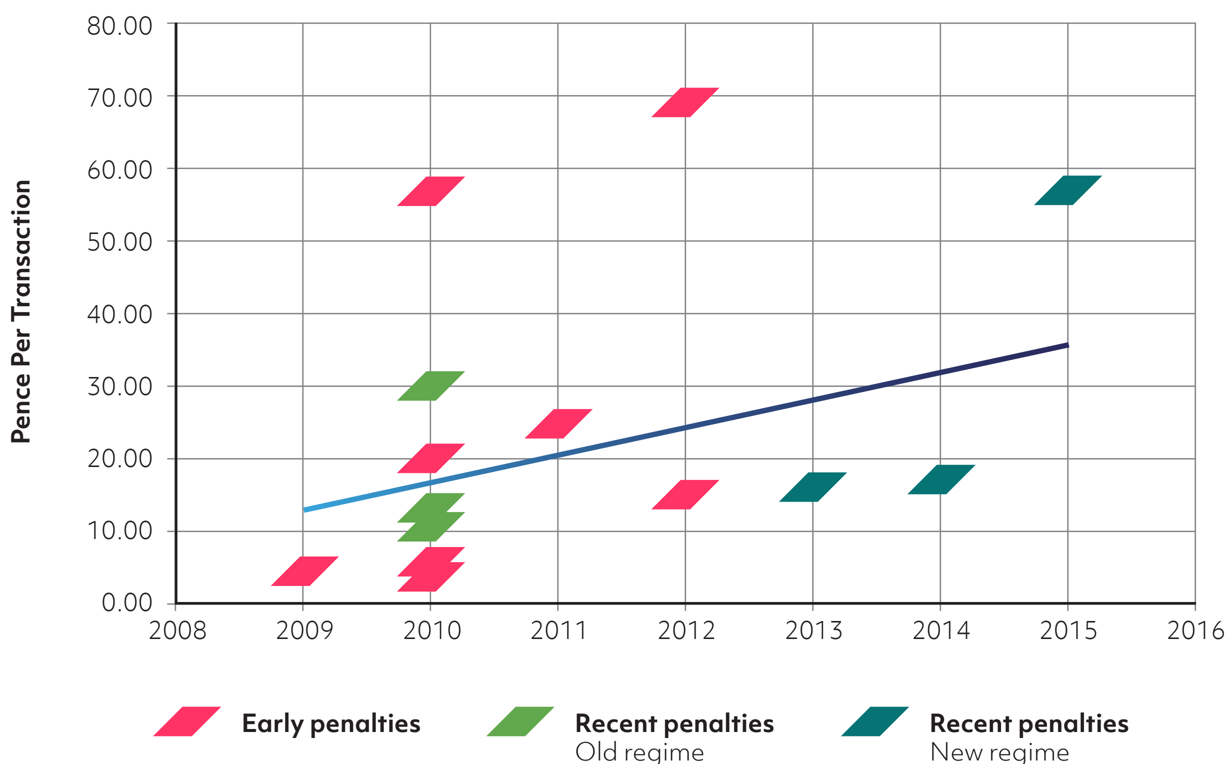

Figure 1.
FCA has issued 12 penalties related to breaches of the transaction reporting obligation under MiFID since it was introduced in November 2007. We have translated the penalty into a cost per incorrect/missing transaction for easier comparison of the 12 cases. For the 3 most recent penalties a separate treatment has been applied depending on if the transactions were reported during the "old" or the "new" penalty regime – this seems to be the current approach taken by the FCA. Under the "new" regime the penalty is directly proportional to the number of missing/inaccurate transactions and recently the base fine was increased from £1 to £1.5 per transaction. With exception of a few cases where the circumstances were found to be extreme, the penalties are clearly upward trending indicating that the FCA is increasingly taking a more serious stand on this type of regulatory breach.

The Current State of Transaction Reporting and the Enforcement

While both EMIR and MiFID applies to all European member states and will be enforced by local regulators in cooperation with ESMA, FCA naturally has an important role given London's position as the financial centre of Europe. Their actions therefore deserve particular attention.

Most market participants will probably agree, at least in private discussions, that the current state of transaction reporting under EMIR and to a lesser extend MiFID (as it is currently more mature) does not meet the levels required by the regulations and as a consequence many firms are arguably in breach.

This raises the interesting question if financial firms necessarily need to be overly concerned about being non-compliant? In case of EMIR the answer so far seems to be no. It is also interesting that despite the derivative reporting deadline being 12th February 2014 and the deadline for valuations and collateral reporting being 11th August 2014, the publication of a consultation paper on those topics by ESMA in November 2014, see [CP], raises a natural question: can this paper be interpreted as an implicit extension of the deadlines (at least in spirit given that the legal deadline is still in force)? In any case the consultation period for this paper has now past and we will expect an update out of ESMA fairly soon which is likely to set the tone for enforcement in the second half of 2015.

A Closer look at the FCA's "New" Penalty Regime

A financial institution faces a number of tangible sanctions from FCA if found non-compliant with regulations ranging from a financial penalty, increased scrutiny, to a mark in the regulatory sin register which is likely to be used as an aggravating factor in potential future cases. Beyond this an obvious concern should be reputational risks associated with regulatory sanctions.

The easiest part to quantify is the financial penalty and to understand the process of determining the size it is helpful to look at "The five steps for penalties imposed on firms" in the FCA's handbook, see [FEE]. Further insight can be gained from looking at the Final Notice of a recent case, see [FCA]. It is worth noticing that the FCA on a regular basis updates their approach to penalties and during the period where the MiFID reporting obligation has been in place this has happened twice, see Figure 2 for an illustration.

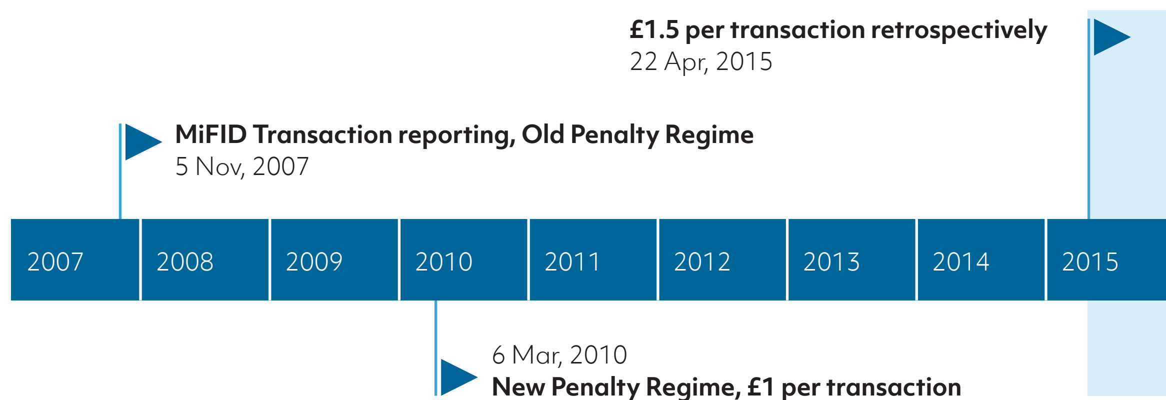

Figure 2.
Over the period the MiFID transaction reporting obligation has been in force the FCA has updated the penalty regime twice. Initially fines were issued based on a subjective view of the breach. In 2010 a more quantitative approach was introduced where the size of the penalty was calculated based on the number of incorrectly reported/missing transactions. The starting point was a base penalty of £1 per transaction. In 2015 this number was increased to £1.5 per transaction applied retrospectively.

The current approach has been labelled the "New Penalty Regime" and is a 5 step process:

1. First it is established if the breach has led to a financial benefit. Historically FCA has not deemed breaches of transaction reporting obligations to have given a financial benefit.
2. **Basis Figure.** Next the number of transaction breaching the reporting obligation over the "relevant period" is identified. Both inaccurate and missing transactions are included in this number. Currently a base fine of £1.5 is then applied to each of the identified transactions.
3. **Seriousness factor.** The next step is to determine the seriousness of the breaches ranging from level 1 – 5 (with 5 being the highest/most serious breach). Transaction reporting offenses has historically been categorised as a level 3 or 4 offense. The level has an associated weighting factor which is applied to the number calculated in step 2. Level 3 has a weight of 20% and level 4 has a weight of 30%. The factors being taken into consideration when determine the level can be found in [FEE].

4. **Mitigating and aggravating factors.** The number calculated by multiplying the basis number and the seriousness factor is then further adjusted depending on the specific case. As an example the regulatory history of the firm in question will be considered. Historically the number from step 3 has been increased by between 10% and 50% in this step.
5. Finally a subjective assessment is made if the number from step 4 is sufficient to deter firms from committing similar breaches in the future. Historically no such adjustment has been made. Firms are also offered a 30% discount from settling the case outside court and historically all firms have accepted this offer.

Closer inspection of the Final Notice reports detailing the historical sanctions taken by the FCA with respect to transaction reporting further reveals, see [FN] for details:

- The first fine was issued 22 months after the transaction reporting obligation under MiFID was introduced.
- While the FCA has different sanctions at their disposal historically breaches of transaction reporting obligations has resulted in a financial penalty to the firm in question. There are so far no cases of sanctions against an individual.
- FCA does keep track of regulatory violations and will use a previous violation against a financial institution when assessing the size of a financial penalty should a new violation arise.
- Fines are calculated based on the number of transactions missing in the reports and the number of inaccurately reported transactions, so companies with a high volume of transactions have a particular incentive to get the reporting right.
- While the FCA naturally give financial institutions a fair chance to get the reporting in place following a new requirement they will fine firms for incorrect reporting right from the introduction of a requirement should the reporting not reach a satisfactory level within a “reasonable” time.
- Unless the character of the breach is extreme is doesn’t appear the FCA distinguish between missing transaction and inaccurate transactions.
- Except in cases where the violation is extreme companies will likely be issued a private warning prior to a financial penalty.

Conclusion

In the case of transaction reporting under MiFID, it took FCA about 22 months to issue the first financial penalty. If a similar time frame is applied in case of reporting under EMIR we should see the first casualty in late 2015 or early 2016. As the number of inaccurate/ missing transactions is a central parameter in calculating the size of the penalty under the current penalty regime, it shall be interesting if FCA will use the same base fine for EMIR as they do for MiFID. The volume of reportable transaction under EMIR is likely smaller than under MiFID and the complexity is higher so a higher base fine might be applied for EMIR transactions to accomplish a similar effect.

In any case, FCA will likely pick a firm it perceives as having particular poor reporting as the initial victim so now might be a good time to make sure that your transaction reporting is at least of "average" quality compared to peers. While this won't guarantee safety from penalties, history suggests the FCA will apply sanctions selectively rather than on a broad scale.

References

[FCA] http://www.fca.org.uk/your-fca/documents/final-notices/2015/merrill-lynch-international

[CP] http://www.esma.europa.eu/system/files/esma-2014-1352_consultation_paper_on_the_review_of_emir_reporting_standards_under_article_9_0.pdf

[FEE] http://fshandbook.info/FS/html/handbook/DEPP/6/5A

[FN] http://www.fca.org.uk/your-fca/documents/final-notices

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