SECURITIES & INVESTMENT
REVIEW
THE JOURNAL OF THE CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT CISI.ORG/SIREVIEW

MARCH 2016

Inside
Review of Financial Markets – see pages 33–44 for in-depth and original academic research

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Cover photograph
Gary M. Prior/Getty

Published on behalf of the
Chartered Institute for Securities & Investment
by Wardour, 5th Floor, Drury House
34–43 Russell Street, London WC2B 5HA
Telephone: +44 20 7010 0999
Fax: +44 20 7010 0900
www.wardour.co.uk
ISSN: 1357-7069

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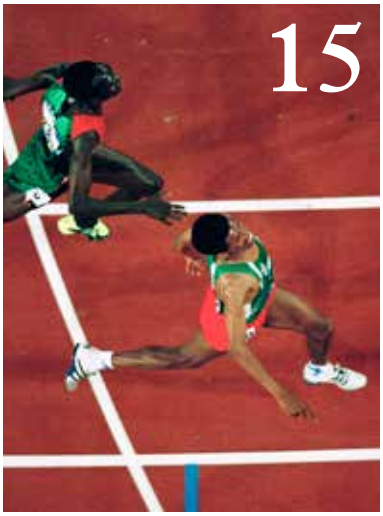

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CISE
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City view

BEHOLD THE REGULATORS' SHINY NEW INSTRUMENTS OF PERSUASION

This month sees the dawn of the Senior Managers Regime (SMR), the UK regulators' plan to hold financial services executives' feet to the fire for their failings. Today, it applies to those at the commanding heights of our industry; two years hence, it will cover all regulated firms.

In December, Tracy McDermott, acting head of the Financial Conduct Authority (FCA), made it plain that a chief purpose of the SMR is to help prevent future crises: "[The Regime] has the capacity to lead a sea change in how UK financial services are seen by all parties. Why? Not because of how it affects ex-post enforcement, important as this is. But because it should drive better, clearer ex-ante decisions fostered by a sense of real responsibility and clear accountability. And thus less problems in the future." The FCA under former CEO Martin Wheatley muscled up a 'shoot first, ask questions later' reputation, a guise which he and his cohorts did little to dispel. The figures tell a different, nuanced story.

Attestations, simple documents signed by named individuals in essence verifying that they understand what is going on around them, created fear and alarm at their debut. The FCA's intent was laudable, if frightening for the dodgy and the dozy: "When we request an attestation, we do so to gain personal commitment from an approved person at a regulated firm that specific action has been taken or will be taken. The aim of an attestation is to ensure there is clear accountability and a focus from senior management on those specific issues where we would like to see change within firms." But in the year to June 2015, there were just 61 attestations, and in the final quarter of last year, a mere ten, five of those in wholesale banks and, tellingly, none in investment banking. Private warnings? Around the same volume, we understand.

Fines levied by the FCA came to £905m in 2015, down from £1.4bn in 2014. But this is a drop in the ocean compared with the £200bn plus in fines and recompenses – twice the annual budget of Britain's National Health Service – levied on the biggest global banks in the five years 2010–2014, analysed in depth in this quarter's *Review of Financial Markets* (pp. 33–44).

Fines levied by the FCA came to £905m in 2015, down from £1.4bn in 2014

Regulators have always had a bad press. The widest-ranging and longest-lasting of all, the Inquisition, tortured far fewer folk in its 700-year reign than is commonly believed; 'showing the instruments' had the desired effect in many cases, without the mess. Sophisticated modern national security agencies know that trick well.

Likewise, the UK regulators' newly burnished instruments for enforcing personal accountability may be more effective in driving McDermott's "better, clearer ex-ante decisions" than actual penalties years down the pike.

But directors and other senior managers must beware. As Francis Kean, a renegade City lawyer turned insurance consultant, warns in this month's CPD article (pp. 48–49), individual liability, while not a feature of the fallout from the 2008 crisis, will now come to the fore. At CISI's February event 'Personal accountability – the countdown for worried directors', Peter Bibby, former head of enforcement at the FCA's predecessor, now back in City legal practice, warned that regulatory investigations are "long, expensive and extremely stressful". The threat will hang over senior people, executives and non-executives, for years – see CISI TV for details.

Three storm warnings, then, for senior managers at the start of this new regime of accountability. First, senior people must reflect that their corporate lawyers' first responsibility is to protect the firm's, not their own, interests. So even the most competent, wise senior managers or directors will have personal legal protection in place, and the contractual means to pay for it, before the regulator comes calling. Firms have not been slow to hang individuals out to dry in the past; that temptation will grow. Second, the new regime departs from the tradition of collective board responsibility, where the courts regarded decisions as having been taken by a majority rather than a group of individuals. The 'Murder on the Orient Express' defence that drew Wheatley's ire no longer works; all senior managers are now in the firing line as individuals. Third, while judges in the Anglo-Saxon world have in the past held true to the 'Business Judgment Rule' as it is expressly called in Australia and the US, meaning they will typically not make their own retrospective judgments on business decisions taken in good faith by directors, SMR gives the regulators new powers to do just that.

These are uncharted waters.

60-SECOND INTERVIEW

With employer development and professional qualifications embedded at the heart of the new apprenticeship standards, more financial services employers are recruiting the next generation of practitioners this way. James Hammill, Director of Professional Apprenticeships and Financial Services at BPP Professional Education, a CISI-Accredited Training Provider, talks about the value of apprenticeships, for both the apprentice and the employer

James Hammill, Director – BPP Professional Apprenticeships and Financial Services

Why choose an apprenticeship over a degree?

The choice for many young people these days is not between an apprenticeship or a degree, but rather between a full- or part-time degree while on an apprenticeship. This follows the introduction of Degree Apprenticeships – the first of which started in September last year – by the Government in a bid to raise standards.

With the introduction of the apprenticeship levy from April 2017, employers will be able to use apprenticeships as a training tool for existing staff of all ages and all levels. Degree Apprenticeships and professional qualification apprenticeships will all form a key part of employers' learning and development budgets in years to come.

How popular are the new Degree Apprenticeships compared with the more traditional kinds?

It's early days to talk confidently about how popular they are, but research tells us that the main attraction of opting for certain school leaver programmes, as opposed to university, is the chance to have a degree funded by an employer while being paid and gaining highly valuable work experience. One group it is proving very popular with is parents. The idea of gaining a debt-free degree and employment from day one is extremely attractive.

What value do apprentices bring to an organisation?

Diversity of the talent pool is most commonly cited as the biggest advantage of apprenticeships. Another is the motivation and hunger to succeed that apprentices bring once they start employment. They have carefully considered their career before opting for an apprenticeship and with this tends to come dedication and loyalty.

What are the essential elements of a successful apprenticeship programme?

Apprentices need to be valued by their employer and be seen to be doing a meaningful job that is leading to an aspirational career. The most successful schemes are structured programmes where the apprentices feel part of a cohort who are celebrated by their employer. There also has to be clear progression paths either through salary, promotion or further studies.

What help is available for apprentices?

The training provider should assign personal tutors for the professional qualification/degree and coaches to support them throughout their apprenticeship. Employers typically allocate mentors and buddies to apprentices in the same way they do for graduates.

- The CISI has worked with a range of employers to help develop three new investment operations apprenticeship standards (Investment Operations Administrator, Investment Operations Technician and Investment Operations Specialist). A number of CISI qualifications are available as the technical unit within these standards, and a range of additional financial services apprenticeships. To find out more information, email *educationdevelopment@cisi.org* or call *+44 20 7645 0714.*

Art in the city

The Bank of England has delved into its vaults this year to find archive photographs showcasing the City as far back as the 1840s.

The Capturing the City exhibition features a vast array of images, ranging from portraits of former Governors to an emergency operating theatre set up at the Bank during WWII.

The exhibition is free to view at the Bank of England Museum until January 2017.

Ask the experts: Will the Common Reporting Standard end secret offshore accounts?

What is the Common Reporting Standard?

As part of the international battle against tax avoidance, the Organisation for Economic Co-operation and Development has developed the Common Reporting Standard (CRS) as the global standard for the exchange of financial account information between revenue authorities. It went live on 1 January 2016 in a total of 54 countries, including the UK and 26 of the other 27 European Union (EU) nations. A further 25 jurisdictions are also committed to joining next year and, overall, a total of 98 jurisdictions have currently indicated their agreement to join. It will cover almost all of the world's major financial centres and traditional 'tax havens'.

It obliges financial institutions (FIs) to identify the tax residence of the beneficial owners of financial accounts. They will then need to report this information to their domestic revenue authority. Reportable persons will include the underlying individual controlling persons of passive investment companies and other similar structures. It will, therefore, pierce the corporate veil far more effectively than other previous attempts at international account information exchange, such as the EU's Savings Directive.

While it is heavily based on the Foreign Account Tax Compliance Act (FATCA) in the US, there are a number of significant differences. For example, it is based on identifying the tax residence of account holders, rather than their citizenship, which is often more fluid.

Who will it affect?

The definition of FI is very widely drawn. As well as banks, it also covers funds, private equity structures, life companies and even certain trusts. Similarly, the definition of a financial account is open, ensuring it is difficult to avoid the scope. While it captures traditional depositary and custodial accounts, there is a generic concept of a "debt or equity interest" in certain types of investment entity which is widely defined.

How can I ensure compliance?

There is a four-stage process to determining the extent of compliance:

- classification – the nature of each entity within the group will be reviewed to determine whether it meets the definition of an FI or, alternatively, a non-financial entity (NFE)
- product base – for FIs, each business line and product will need to be reviewed to establish whether any meet the definition of a financial account
- customer due diligence – the tax residence of each beneficial owner of a financial account will need to be considered. For new accounts, a self-certification will normally be obtained (for example, the British Bankers' Association has published a draft). However, any accounts opened on or before 31 December 2015 will also need to be reviewed in order to identify whether there is any indication of residence overseas, when further enquiries will need to be made
- reporting – the first return is due with HM Revenue & Customs (HMRC) by 31 May 2017 and annually thereafter.

What are some of the potential pitfalls?

Compliance with the new regime will be monitored by HMRC and built into its risk-assessment model. Accordingly, non-compliance is not an option.

It should be recognised that information will be passed to overseas revenue authorities which will use the information as the basis for their enquiries. If incorrect information is reported, they may seek restitution of the costs of defending any subsequent tax enquiries.

Any changes to business lines or products may bring an entity into or out of scope of the definition of FI. Alternatively, any new products launched by an FI will also need to be considered to ascertain if they are financial accounts. There will also need to be processes in place to identify any potential changes in the tax residence of beneficial owners or, indeed, changes in the beneficial owners themselves. This will be a particular issue for listed funds, which will need to run periodic sweeps of their customer base.

Customers whose financial accounts are identified as potentially reportable will need to be notified of this. They will need to be advised by 31 January immediately following the identification. However, FIs may also wish to consider providing full details of the information that will need to be exchanged, as there is no 'tipping-off' offence.

> HMRC will monitor compliance, building it into their risk-assessment model

It should also be noted that, even though the legislation is now live, there are a number of potential legal conflicts that have yet to be resolved. In particular, given the future expansion plans of the CRS, it may be logical to capture the necessary information from all customers. However, there is still an ongoing debate to ascertain whether retention of such information could be in breach of the Data Protection Act 1998 where the account holder's jurisdiction has yet to join the CRS.

It is, therefore, essential to ensure that suitable governance procedures are in place, documented and adhered to. This area will be monitored by HMRC.

In the meantime, the US remains outside the CRS, believing that FATCA serves its purpose. Accordingly, FIs will need to run both systems for the foreseeable future.

Rob Smith, Senior Manager, Financial Services Tax Team, Mazars LLP

The knowledge: Vulnerable customers

The FCA requires companies that sell financial products to ensure that vulnerable customers or those "susceptible to detriment" are given an "appropriate level of care and consideration" to allow them to access products and services. Sandie Dunn, People Development Manager at Legal & General Investment Management – Retail (LGIM Retail), gives some advice on this, based on the FCA's *Occasional paper no.8: Consumer vulnerability.*

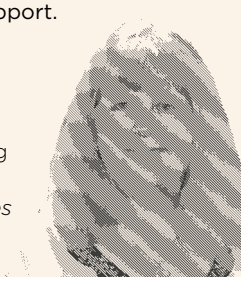
1 **Identify the Triple P.** Find the people, processes and products that may be preventing customers gaining equal access to the company's services. Look at these through the lens of different vulnerabilities and determine the barriers that may not otherwise be apparent. For example, there may not be facilities for deaf customers to communicate in real time, so they may be forced to give security information to someone else. Or staff might not understand differences in Power of Attorney, which could result in wrongly accepting an instruction and contributing to financial fraud. Or there may be products that discontinue if the monthly investment falls below a certain amount, which could exclude customers at their most vulnerable time.

2 **Involve the experts**. Consult experts or any organisation relevant to your firm's customer base. For example, LGIM Retail recently consulted experts such as Age UK and the Alzheimer's Society, and spoke to clients at New Horizons Day Centre for people with illnesses or disabilities who require additional support. This resulted in a film being produced for staff training purposes. It highlights the various impacts of vulnerabilities, such as communication difficulties, embarrassment, or feeling rushed or confused by the volume of information requested or given. If adequate support is provided to overcome these effects, it allows vulnerable customers to retain their independence, and fulfils the requirement for "care and consideration" stated in the FCA's paper.

3 **Improve the people**, processes and products that are causing issues or making customers more "susceptible to detriment". Give staff the flexibility and autonomy to make changes that allow them to provide the "appropriate care" required by the FCA. Simply making information available on the intranet is not enough – the 'best practice' case studies in the FCA paper show that the best companies have assessed their barriers and made adjustments on a holistic basis.

4 **Extend the principles** of the company's Equality and Diversity policies to your customer base. Embrace diversity and adapt policies so that customers are not automatically disadvantaged or vulnerable at critical times when they need additional support.

Further information
For a full list of CPD training courses, visit *cisi.org/courses*



MEMBERSHIP UPDATE – YOUR BRANCH

Upon joining the CISI, all members are allocated a local CISI branch to stay up to date with CPD and networking opportunities.

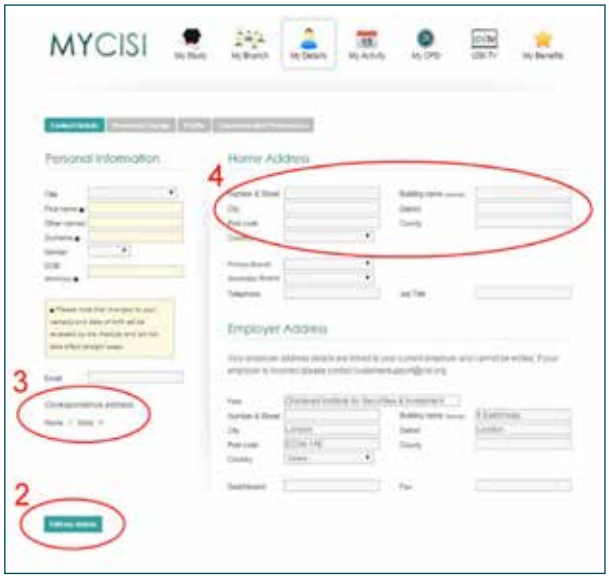
We've now enhanced our systems, so that your local branch is automatically set to your preferred correspondence address and postcode. You can also find out about CPD and networking opportunities in another branch by providing us with your secondary address (home or work).

For example, if you live in London but travel to the south coast for work, you can elect to receive communication from both our London branch and our south coast branch.

How do I amend my address and local branch?

1. Log in to MyCISI. You will need your registered email address and password
2. Click 'Edit my details'
3. Choose 'Home' or 'Work' as your preferred correspondence address
4. Update your home address. To update your employer address, please contact us
5. Your local branch will now be automatically linked to the postcode of your preferred correspondence address.

- If you have any queries, please contact *customersupport@cisi.org* or *+44 20 7645 0659*



Review of Financial Markets (RoFM)

This edition of the *S&IR* contains the ninth issue of the CISI's academic journal, *Review of Financial Markets* (*RoFM*), starting on page 33.

The 12-page publication includes four diverse pieces from experts in their field.

Dr Hatim El-Tahir, Leader of Deloitte's Middle East Islamic Finance Knowledge Centre (IFKC), Manama, and Associate Professor of Finance at Henley Business School, Reading, presents research on the appetite for 'euro sukuk' among CISI members and others.

Kenneth Murray, Head of Forensic Accounting at Police Scotland, analyses the 'identity crisis' of money laundering.

Daniel Broby, Chartered FCSI, Director of the Centre for Financial Regulation and Innovation at Strathclyde Business School, probes the mismatch between financial innovations and the pace at which updated regulations follow.

Lastly, a collaboration between Roger McCormick, Managing Director at CCP Research Foundation and Visiting Professor at the London School of Economics, and Chris Stears, Chartered MCSI, Research Director at CCP Research Foundation and a Solicitor and regulatory adviser, on the subject of rising conduct costs in banks.

George Littlejohn MCSI, Senior Adviser to the CISI, is Guest Editor of this issue of *RoFM*.

Welcome to the *S&IR*'s new regulatory section: Change

Change covers the key regulatory changes in the finance industry in the last quarter.

Previously a separate publication that served the compliance community, it has now been incorporated into four pages of the *S&IR*, with the aim of bringing important regulatory updates to the attention of all members. Change's Editor is Christopher Bond, Chartered MCSI, Senior Adviser to the CISI. He says: "I hope very much you will understand that Change – as its name shows, and like regulation itself – is constantly evolving and that you will support and enjoy the new approach."

Turn to page 29 to read his full introduction and to be informed of regulations relevant to your industry.

Check out our digital edition

Keep up to date on developments through the digital edition of the award-winning *Securities & Investment Review*

CISI members worldwide can log in using their tablets or smartphones and read news and features on the issues that matter to them.

• View at *cisi.org/sireview*

The *S&IR*'s quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 65 modules covering topics including anti-money laundering, the UK Bribery Act, information security and data protection. The answers are on page 11.

1. Which of the following most accurately describes the difference between financial planning and financial advice?

A Financial planning is a specific regulated activity, whereas financial advice is not
B Financial planning relates to developing a financial plan, whereas financial advice involves the implementation of the plan
C Financial planners must be approved by the regulator, whereas financial advisers do not need to be
D Financial advice often involves the recommendation of a specific product, whereas financial planning may or may not involve specific product recommendations

2. Which of the following could result in an inheritance tax liability?

A Gifts on marriage within the relevant limits
B Business assets
C Charitable donations
D Payments by parents for the education of their children

3. What is the upper limit to the amount of money that can be raised by a crowdfunded project?

A £10,000
B £1,000,000
C There is no upper limit
D A limit is set by the crowdfunding site depending on the project

4. The equity funding gap can be defined as:

A The deposit required when borrowing money from a bank
B The fees charged by a venture capitalist for due diligence
C The maximum amount a company can borrow from a private equity firm
D The demand for venture capital minus the supply of venture capital

Access to Professional Refresher is available on an annual licence basis. The full suite of modules is free to CISI members or £250 for non-members. If you or your firm would like to find out more about Professional Refresher, visit *cisi.org/refresher* or contact the CISI on *+44 20 7645 0777*.

BACK STORY

Debbie Clarke, Corporate Finance Partner and Head of M&A, Moore Stephens

Having studied biological and medicinal chemistry, a summer job in a lab helped Debbie realise that medical research wasn't the career for her. "I wanted a role that gave me client access; being in a lab on your own doesn't do this," she says. It did, however, give her a better understanding of what she wanted to do. "The bit I enjoyed the most was analysing numbers; chemistry has a lot of analytics." Both these factors meant a City career seemed a good option. This led to Debbie taking her MBA, to identify which part of the industry she wanted to join.

Debbie began her career at HSBC straight after graduating, following work experience with the bank. Joining as a generalist on the equity capital markets side of corporate finance, she has become more specialised as her career has advanced, enjoying the pure advisory side of mergers and acquisitions. "It allowed me to get much more involved with clients." It is still client interaction that Debbie enjoys most. She explains: "There is nothing better than a completion meeting with a very happy client who has just done the deal they have been thinking about for the past seven years." Since HSBC, Debbie has held roles with PwC, Mazars, Chantrey Vellacott and her current company, Moore Stephens.

> "There is nothing better than a completion meeting with a happy client"

Debbie's gregarious nature, coupled with a competitive spirit, is reflected in her life outside work. A keen athlete, she competes in duathlons and triathlons, having twice represented GB as an Age Grouper – in September 2014 and October 2015. However, she says preparation for these competitions often requires her to tap into her professional skill set. "You ensure that you plan out your time from early in the season until you come across the finishing line, to make sure you are at maximum capability. You also have to do this with every transaction you work on; it's all about project management and planning. You would be surprised how many people from the City are competing in duathlons and triathlons nowadays. I have made some great friends and business contacts – it is like an extension of business networking."

Debbie chairs the CISI Corporate Finance Committee, is a member of several forums, is a huge advocate of CISI TV and believes that online modules have made a real difference to continuing professional development (CPD) in recent years. "We all work in ever busier markets. Being able to do electronic training modules that fit in with your working day takes away any excuses for not doing enough CPD as the year goes on." Debbie has also been working with CISI on its corporate finance exam, something which she believes can make a real difference. "I'm quite passionate about making sure there is a better level of consistency of advice that is given across the industry. I think the exam is a good way to improve that and help younger members of the industry come through."

Events preview

The CISI offers plenty of opportunities to help you meet your requirements for professional development. Below are just some of the highlights of the Institute's events programme. For further information, take a look at the events flyer which is included in UK copies of this issue of the *S&IR*.

CONFERENCES

25–26 MAY

PARAPLANNERS CONFERENCE

Chesford Grange, Kenilworth, Warwickshire

The CISI's first Paraplanner Conference will focus on a variety of relevant technical and personal development topics.

14 JUNE

ACCREDITED FINANCIAL PLANNING FIRMS' CONFERENCE

The Grange Hotel, Holborn, London

The conference content will be tailored to the needs of firms, with a dinner taking place on the evening of 13 June.

ANNUAL DINNERS

11 MARCH Jersey Annual Dinner
12 MAY Liverpool and North Wales Annual Dinner
6 OCTOBER Bristol Annual Dinner

OTHER HIGHLIGHTS INCLUDE

14 March: Estate planning and inheritance tax (Yorkshire)
15 March: How technology is driving a revolution in how we interact with pensions, achieving better outcomes through identifying and overcoming behavioural biases (Bristol)
15 March: Securities class actions (London)
15 March: Business succession planning and journey to being a financial planner & AlphaDEX (Wales)
16 March: No cashflow, no comment! The importance of investment processes (Essex)
17 March: Goal-based investing and planning for profit (Birmingham)
17 March: Advising on tax-efficient investments – due diligence and suitability & wowing by design (south east)
22 March: Spring regulatory update – what should concern you now (London)
22 March: Spring Budget analysis (Bristol)
23 March: Interactive ethics workshop & the science of persuasion & carrying out due diligence on enterprise investment scheme providers (East Midlands)
30 March: Environmental, social & governance (London)
14 April: CISI Annual Awards (London)

IN-HOUSE TRAINING

The CISI delivers in-house training courses for members and non-members, spanning a variety of skill areas. If you have a team that requires training, please contact Alex Xavier (Assistant Director, Member Services) on *020 7645 0725* or *alex.xavier@cisi.org*

- If you have an idea for an event or would like to contribute at one of our events, please email *cpdevents@cisi.org*
- For details of conferences, training courses, CPD and social events available to members, visit *cisi.org/events*

A second chance for share schemes

HAVING FALLEN OUT OF FAVOUR FOR MANY BUSINESSES, IS IT TIME TO TAKE ANOTHER LOOK AT INTRODUCING EMPLOYEE SHARE SCHEMES?

ANTHONY HILTON JOHANNA WARD

Employee share ownership used to be a really big thing. At a time when Britain had a perhaps unjustified but nevertheless firmly established reputation for bad industrial relations, it was thought that things might improve if more employees had a stake in the business, because they would understand how they were damaging their own financial interests as shareholders by being unco-operative as workers. Accordingly, employers were encouraged to set up savings schemes where a small amount was taken out at source from the monthly pay packets, the Government helped with a mild tax break and the accumulated money was used to build up personal shareholding for the employees.

Unfortunately, the idea that 'owner employees' would work harder to secure the success of the business did not work. Firstly, the employees did not really understand what they had – they knew their shares were worth a bit of money but the link between the day-to-day value of their shares and their day-to-day activities in the company was too remote to be meaningful or motivational. The gyrations of the stock market seemed wholly disconnected to the world in which they lived.

Second, the dividends on the shares were ploughed back directly to increase the size of the holding, so they did not even get to appreciate at first hand how this financial flow was ultimately linked to corporate profits. And third, even when employees had participated in a scheme for a long time and built up a holding of some value, it was still almost always of secondary importance when set against their earnings. Their financial interest as salary or wage earners trumped their interest as shareholders, so it made sense to press for higher wages, even if this did dent corporate profitability.

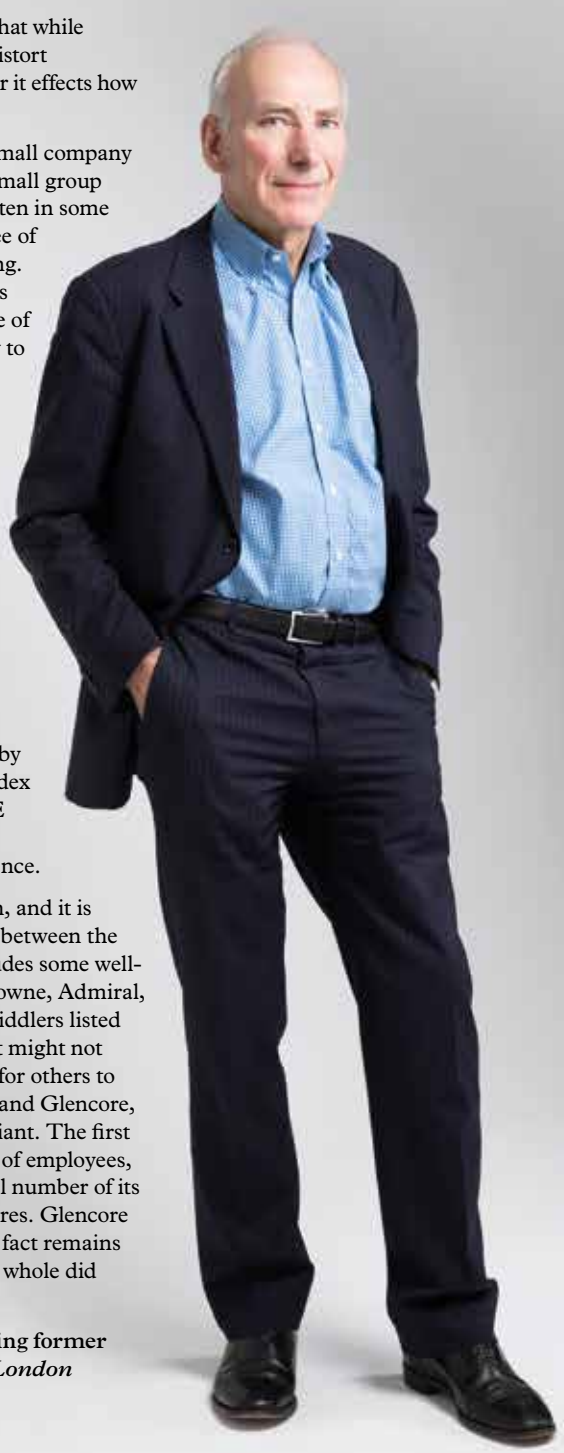
For all these reasons, widespread share ownership among all employees is no longer fashionable. That is not to say the concept is dead. Selective share ownership is still seen as motivational if targeted in the form of options or grants to key executives, linked in some way to their performance and the hitting of targets.

It is debatable, however, whether it is the prospect of receiving shares that makes the difference, or if the same effect would be achieved if the executive received the equivalent amount in cash. Indeed, if one wants to be provocative, there is a raft of academic evidence suggesting that while performance pay will most certainly distort behaviour, it is much less clear whether it effects how hard or intelligently a person works.

Share ownership is also common in small company start-ups. This is partly because the small group of people launching a company are often in some sort of partnership, so there is a degree of co-ownership right from the beginning. But it is also a useful way to keep costs down. A grant of shares with the hope of future riches is a well-established way to persuade staff to work for less.

But perhaps more mainstream companies should dust off their employee share schemes and make a real effort to get more people on board. According to an analysis prepared for ESOP, a charitable body which promotes employee share ownership, listed companies operating such schemes significantly outperform the market. An index has been constructed of those public companies where 3% or more of the equity is held outside the boardroom by employees. In 2015, the FT ESOP index rose 26.4% against a rise in the FTSE All-Share of just 0.8%. This was its fourth successive year of outperformance.

Of course, correlation is not causation, and it is notable that there is little in common between the companies in the index. The list includes some well-known names like Hargreaves Lansdowne, Admiral, Next and BT as well as a long tail of tiddlers listed on AIM. It also includes a couple that might not immediately be thought of as models for others to follow – Mike Ashley's Sports Direct and Glencore, the commodity trading and mining giant. The first is noted for its fairly robust treatment of employees, the other for the fact that a substantial number of its key traders are already multimillionaires. Glencore was of course a drag last year, but the fact remains that employee-owned companies as a whole did outperform their peers.



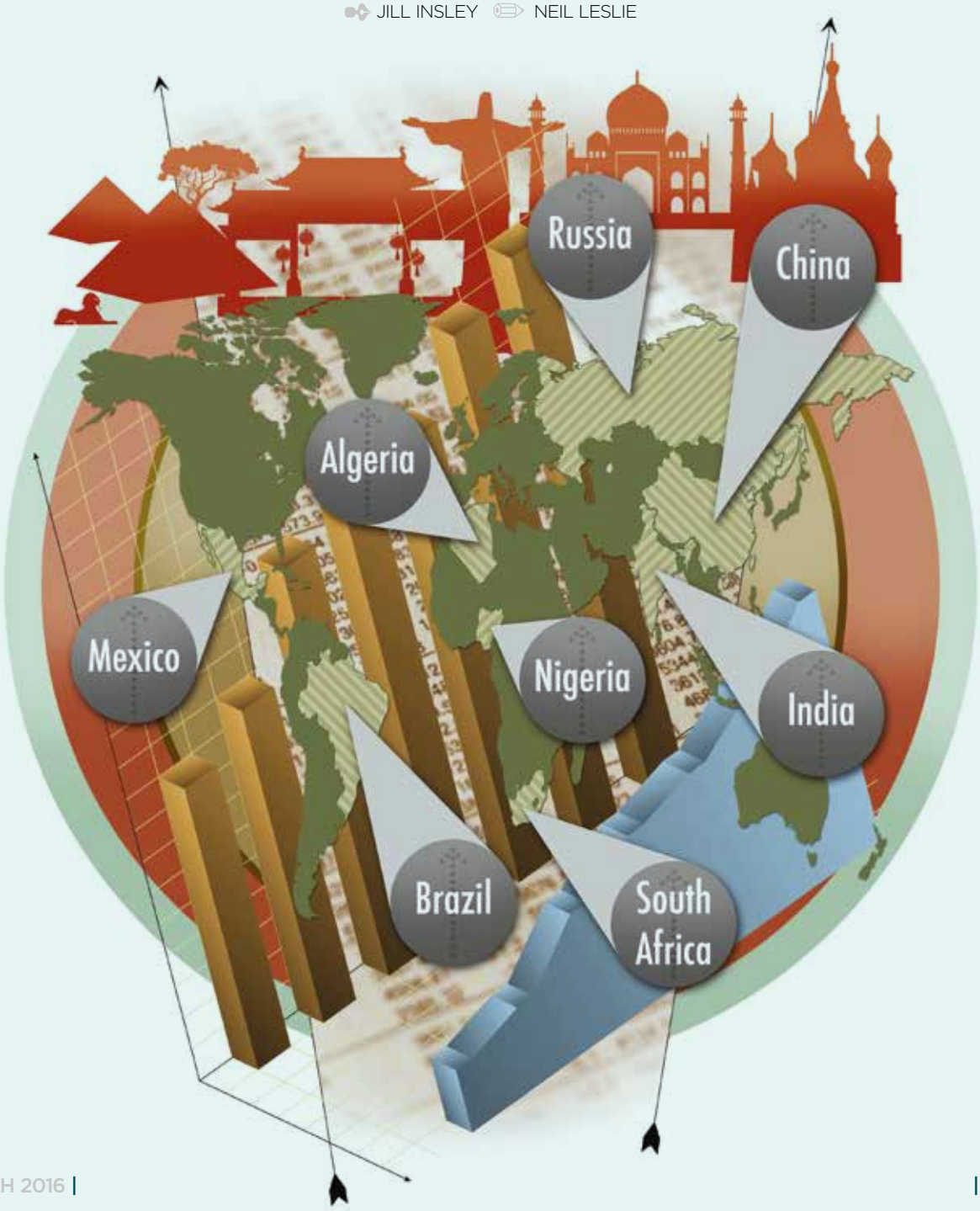
Anthony Hilton is the award-winning former City Editor of *The Times* and the *London Evening Standard*

In the know answers: 1.D, 2.B, 3.C, 4.D

Getting in early

FOR MANY INVESTORS, THE PROSPECT OF SHARES IN EMERGING MARKETS CAN BE ATTRACTIVE. BUT FOR THOSE NEW TO THE AREA, IT CAN BE HARD TO KNOW WHERE TO START. IT IS IMPORTANT TO FIRST UNDERSTAND WHAT DEFINES THESE MARKETS IN ORDER TO APPRECIATE THE CHALLENGES

JILL INSLEY NEIL LESLIE



The 2016 New Year celebrations were cut short for investors as concerns about a slowdown in the growth of China's GDP resulted in sharp drops in Chinese share prices and closure of its stock markets twice within a week.

The Chinese market volatility triggered falls in stock markets around the world, and is just the latest in a line of bad news for emerging market (EM) investors who have been hit by a series of crises in the past few years.

EM funds are the investment of choice for many long-term investors who want to diversify their portfolios. The idea of an EM fund is to capitalise on immature but fast-growing economies that benefit from young, increasingly educated populations and growing consumer consumption, and which have so far avoided expensive welfare states.

Investment experts have tried to ease understanding of the way EMs function by forming notional groups: Jim O'Neill, former Head of Global Research at Goldman Sachs, led the way with BRIC, the acronym for Brazil, Russia, India and China. Other groupings include EAGLE (Brazil, China, India, Indonesia, South Korea, Mexico, Russia, Taiwan and Turkey) and SANE (South Africa, Algeria, Nigeria and Egypt).

But the groupings can be misleading as the countries often have little in common, says Mark Dampier, Research Director at Hargreaves Lansdown Asset Management. "Each EM has its own characteristics: the economies of some are dependent on the mining and exporting of natural resources, while others make use of low priced labour to produce cheap consumer goods. They tend to have immature political systems, and may be prone to coups and civil unrest. Some may lack their own internal market for the products they make and are dependent on exporting. Others may have increasing levels of education, collection of taxes and a fast growing middle class that is keen to spend money on consumables and a higher standard of living," he says.

"Some rely on just one or two sectors and their stock markets have just a few shares that are difficult for foreign investors to buy and sell, while others operate accessible and liquid stock markets."

HISTORY IN THE MAKING

The concept of retail investment in EMs first started in the 1980s, with MSCI developing its first EM indices and investment group, Templeton (now Franklin Templeton), launching specialist portfolios for ordinary investors. In the early days, professional investors faced difficulty in gaining information about and access to many of the local markets. The trading conditions meant – and still do mean in some markets – that movements of relatively small amounts of money can have a big impact on share prices. Mark Mobius, who ran the Templeton Emerging Markets investment trust for 26 years until last October, and still remains on the trust's portfolio management team, refused to accept more than $100m of clients' money at launch because the sector was so small and immature.

Emerging market funds are the investment of choice for many long-term investors

The 1980s and 1990s were difficult decades for EMs. In their *Global investment returns yearbook 2014*, Elroy Dimson, Paul Marsh and Mike Staunton analysed the prevalence of crises – banking, currency, inflation, stock market, and domestic and external sovereign bonds – within EM and developed market (DM) countries. They found that emerging countries, on average, experienced 15 or more crises per decade during the 80s and 90s, compared with fewer than five for developed countries.

The average EM was almost twice as volatile as the average DM at the end of 1980. But the research also showed that by the end of 2013, the average EM was only 10% more volatile. "Whether we look at the absolute or relative volatility of emerging equity markets … the overall trend has been downward. This is consistent with volatility declining over time as emerging countries develop," said the report. But as China is currently demonstrating, even markets that have advanced some way along the road to maturity can react violently to an unwelcome development, such as a slowdown in growth.

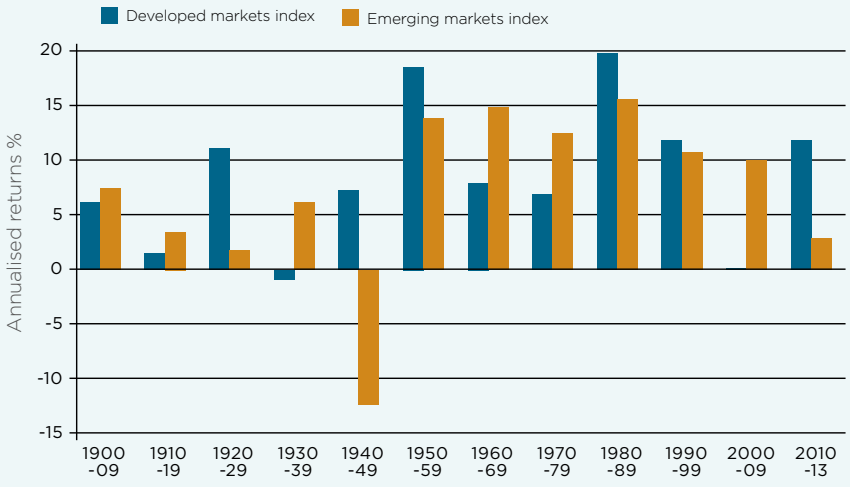
Many analysts and investors believe that the impact of a crisis can be magnified by contagion, where an event in one market triggers a chain reaction across others, possibly spilling into DMs. The 1998 Russian default is a classic example, spilling over regionally into other former Soviet republics but also affecting Brazil, Mexico, Hong Kong and the US through the collapse of the Long-Term Capital Portfolio hedge fund.

EMs have proved particularly sensitive to events in the US. In the past 15 years, three big downturns in EM performance coincided with the 2001 US recession and Argentine debt default, the 2008 global credit crisis, and in 2013, when former Federal Reserve chairman Ben Bernanke indicated he might end the Fed's quantitative easing programme.

READY TO PERFORM

Despite these crises, EMs easily outperformed DMs in the first decade

EMERGING AND DEVELOPED MARKETS: RETURNS BY DECADE



Source: Elroy Dimson, Paul Marsh and Mike Staunton using data from MSCI Barra and S&P/IFCG

of the 21st century. Dimson, Marsh and Staunton said: "While the start of the 21st century was a lost decade for DMs, EM equities powered ahead. From 2000 to 2010, the annualised return on the MSCI EM index was 10.9% versus just 1.3% for DMs."

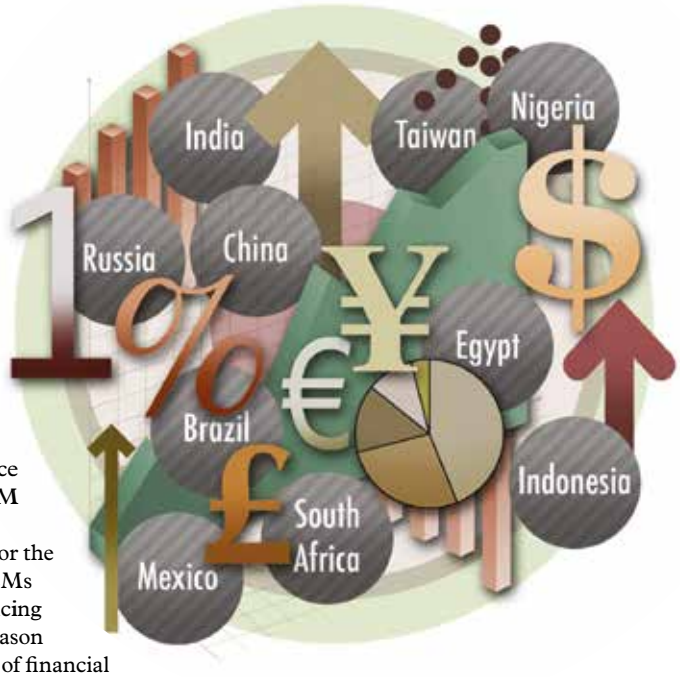
The improved performance may be partly attributed to improved investor confidence following the publication of two reports in 2001 and 2003 on the BRIC economies, which asserted that by 2050 they could be bigger than those of the G6.

"These countries took a free ride on the coat tails of US QE and ultra-low rates"

EMs have also worked on the structural problems that make them so vulnerable to their own crises and contagion from others. US economist Nouriel Roubini argued recently that many countries are more financially sound than they were a decade or so ago, "when financial fragilities led to currency, banking and sovereign debt crises".

Although the MSCI EM index fell by 53.33% during the 2008 credit crunch, the global crisis encouraged the view that the developed world was entering a long decline and that the best prospects would be found in EMs. The index bounced back by 78.51% in 2009, and the balance of money flowing into EM equity funds soared from €2.42bn in 2008 to €51.23bn in 2012.

Since 2010, however, investors in EMs have experienced a true rollercoaster ride (see the graph below which shows MSCI EM compared with MSCI World or US S&P), and the MSCI EM index is down 24.7% over the year at the time of writing.



PROSPECTING

The US has been a ready source of credit for, and a buyer of, EM goods and resources. With US interest rates on their way up for the first time in nearly a decade, EMs now face the challenge of servicing increasingly expensive debts. Jason Hollands, Managing Director of financial planning firm Tilney Bestinvest, says: "These countries took a free ride on the coat tails of US QE and ultra-low rates, using the opportunity to borrow very cheaply, but as the US has stepped back from such measures and the dollar has strengthened, the cost of servicing these debts has spiralled."

The slowdown in China and knock-on impact on its demand for industrial commodities is also expected to continue to cause ongoing problems for EMs. Hollands is cautious about the near-term prospects for EMs and expects further outflows from funds. "That said, EMs could yet turn out to be 'a wild card' investment in 2016, as they are certainly cheap on most metrics and arguably so much negativity is priced in. On a forward price/earnings ratio, EMs are trading at around 11 times earnings, compared with US equities on 16.1 times, and would be much cheaper were India and Taiwan stripped out. Another measure is Price to Book: the EM Index is on a 1.4 multiple, whereas the 10-year average has been 1.6 times.

"In many ways, EM valuations have better reflected the risks facing the global economy than DMs, so we don't rule out the prospect of these markets bottoming out during 2016. I'm just not sure we are there yet."

Mobius expects the recent market volatility to continue during 2016, and says it is something investors will need to learn to live with. "In the case of China, the Government's efforts to maintain stability on the one hand and to allow a freer market on the other is a difficult balance to achieve," he says.

But he adds that Franklin Templeton is "not terribly concerned" about growth in China or its long-term investment prospects. "We would dub current 2016 projections of about 6% in gross domestic product growth as quite strong, given that the size of the economy has grown tremendously in dollar terms from that of a few years ago, when growth rates were stronger but with a smaller base.

"This is another aspect we think many investors may be missing when they see growth slowing. The fundamentals in China are still excellent, in our view. It is one of the fastest-growing economies in the world, even if the growth rate has decelerated."

CUMULATIVE INDEX PERFORMANCE – GROSS RETURNS
(USD) (JAN 2001 – JAN 2016)

Source: MSCI Indexes

Getty

Going for gold

AS ONE OF THE MOST REVERED ATHLETES OF ALL TIME, HAILE GEBRSELASSIE KNOWS WHAT IT TAKES TO SUCCEED. HE SPEAKS EXCLUSIVELY TO *S&IR* ABOUT BALANCING AN ELITE RUNNING CAREER WITH A GROWING INVESTMENT PORTFOLIO

GARETH FRANCIS

It is not every day you get to speak to somebody who is regarded as one of the best athletes of all time. Rarer still is to find that person has combined their achievements with a successful investment career. But with a widening portfolio and a passion to improve his country, Ethiopian distance runner Haile Gebrselassie is now aiming to prosper in business as much as he did in sport.

Gebrselassie took his first steps into investment 17 years ago, not even halfway through his monumental running career. "My first investments were in real estate; I was building and renting out property. Now I have many other things: hotels; farms; I sell cars and so on. I am very proud of my business; I employ more than 1,700 people in my company (Haile & Alem International)."

It's certainly impressive to have achieved such business success in less than two decades, but with two Olympic gold medals, four consecutive world championship titles, and 27 world records over the course of his athletics career, going above and beyond expectation is nothing new for the man they call 'the Emperor'.

TOUGH START

Even with such a regal nickname, it is difficult to overstate the respect and reverence Gebrselassie is given in athletics circles. When nine people were selected to carry the Olympic flag into the stadium at the London 2012 opening ceremony, only two of them were athletes. One was Gebrselassie, the other, Mohammed Ali. And while the former heavyweight champion of the world has been known to

Getty

make the odd audacious claim about his own ability (and rightly so), when I speak to Gebrselassie, in spite of his achievements, he remains as humble as his roots.

Gebrselassie is one of ten children. As a youngster, he would run 10km to school every morning and home every evening. Carrying his books each way, these journeys formed his distinctive running style, with his crooked left arm. He recalls his childhood, when he would listen to the radio commentary of his favourite runners in secret (his father did not want him wasting either time or batteries on such things). A role model to so many, he recalls his own hero at that time. “For me it was [fellow Ethiopian] Miruts Yifter, who won the gold medal in the 5,000 and 10,000 metres at the 1980 Moscow Olympics. When I was seven years old, he was the one winning both events. That was who I wanted to be like.”

Gebrselassie was making waves of his own 12 years later, winning both the 5,000m and 10,000m at the 1992 Junior World Championships in Seoul. The next year he was running in the senior competition in Stuttgart, taking home his first of four successive gold medals at the event.

ELITE STATUS

In 1993, he set his first world record, running the 5,000m in 12 minutes and 56.96 seconds. This became something of a habit, as he continued to shatter the best times over this distance and the 10,000m.

However, the race he is most proud of was to come later. “I broke many world records, 27 in total. I won many races and many world championships. But my best achievement was in the year 2000 at the Sydney Olympics when I won the 10,000 metres gold medal. It was so close between me and [Kenyan athlete, Paul] Tergat.” He is not joking. Just 0.09 seconds separated the two, closer than the winning margin in the men’s 100m final that year.

It was around this time that Gebrselassie began investing, and if beginning a new career on the side was not a tough enough test, after two decades of track success, he decided the time was right to make the transition to marathon running. Taking on a different surface and distance is no mean feat and is one of the challenges he admits he found the most difficult. Yet, perhaps unsurprisingly given his track record, he made a success of it, with several high profile wins, including a world record time at the 2007 Berlin Marathon that he went on to break again a year later.

GOLDEN TOUCH

With more than 200 career medals, you would be forgiven for thinking that Gebrselassie might have gathered enough precious metal for one lifetime, but this has not stopped him investing in a gold mine, a venture he says is one of his toughest. Yet the grit and determination he showed as a runner does not seem to have faded.

He still uses the drive that took him to the pinnacle of athletic accomplishment to succeed in the investment world. He sets himself targets and pushes himself to achieve them. “For me, sport and investment do have similarities. In both worlds, the goal is to be number one, the goal is to win, the goal is to achieve something.”

And while taking on opponents at the highest level of athletics may seem a monumental challenge to most, Gebrselassie adds that business can sometimes feel more competitive. “When you’re an elite athlete, you are competing with only a few people. When you work in business, you have to compete with many of them; thousands of people.” The investment world can require a patience that Gebrselassie admits he is still learning. “When working in business, like running, I want to finish things very quickly. I want to be in front.”

Gebrselassie has huge enthusiasm for both areas of his life, and still enjoys some of the necessities that become more of a chore than a pleasure for many. It is not unusual for executives and athletes alike to tire of the long trips required to ply their trade around the world, yet the ever-humble Gebrselassie remains grateful for all the opportunities both lives present to him. “With running I had the chance to travel to many countries and see many things around the world. In investment it can be similar. While the reasons to go are not the same, they are both great experiences.”

STAYING ON TRACK

While his business takes up the vast majority of his time, he still finds time to run every day and has stayed involved with the sport he ruled for so long.

THE CV

1993 WINS FIRST OF FOUR WORLD CHAMPIONSHIPS

1996 WINS FIRST OLYMPIC GOLD MEDAL

1999 BEGINS INVESTING, STARTING IN REAL ESTATE

1999 OPENS FIRST CINEMA

2000 WINS SECOND OLYMPIC GOLD MEDAL

2009 FOUNDS HYUNDAI IMPORT BUSINESS

2013 COFFEE PLANTATION AND GOLD MINE OPENS

2015 RETIRES FROM COMPETITIVE RUNNING

Getty

While arranging our interview, he was in Rio to discuss the upcoming Olympics, and he'll be heading back to Brazil in the summer, working as a commentator.

Gebrselassie is also a proud family man. He has been married to Alem since 1996 and the couple have a son and three daughters. His wife is his business partner, and while he is involved in all his investments and the making of key decisions, his brother Assefa runs it on a day-to-day basis.

We close our conversation discussing the opportunities that Gebrselassie's home country now presents for foreign investors. He believes the time is right for more foreign investors to make an entrance into its emerging market.

He is a great advocate of Ethiopia and he has also expressed interest in entering its political sphere.

Gebrselassie practises what he preaches. His business headquarters, the Alem Building (named after his wife), is located in the capital, Addis Ababa, while all his investment activities are within the country.

"Ethiopia is a country where you can come and make something good"

He has financed seven of the tallest buildings in the city, is the country's sole importer of Hyundai vehicles, has opened a cinema and, naturally, a gym. He has also set up two schools in the country, recognising the importance of an education, despite having little himself (his agent Jos Hermens has previously said that with this lack of formal training, Gebrselassie takes an intuitive approach to his business).

He hopes the country will attract more investment and says the possibilities for success are there, should emerging market investors look for them.

"Ethiopia is a country with many resources. We have gold, minerals and other mining resources. We also have farming. There is cheap labour and nearly 100 million people. It is a country where you can come and make something good."

Making the case

APPEARING AS AN EXPERT WITNESS CAN OFFER PROFESSIONAL AND FINANCIAL BENEFITS, YET THERE ARE RISKS AS WELL. THESE CAN RANGE FROM CAREER SETBACKS TO FACING A LAWSUIT OF ONE'S OWN. SO, HOW CAN YOU GO ABOUT BECOMING A SUCCESSFUL EXPERT WITNESS?

HEATHER CONNON GETTY

Expert witnesses can play a crucial part in legal proceedings, helping the court understand complex issues through technical analysis of the facts. They can be particularly in demand in financial cases, where the complexities of market manipulation, risk analysis or insider dealing may need detailed explanation to help the judge appreciate the issues involved.

It can also be rewarding for the individual, and not just financially. Nicola Cohen, Chief Executive of The

Getty

Academy of Experts, one of the professional bodies in this area, says: "Being an expert witness can be very challenging and interesting. It can put you at the forefront of the industry, showing you are at the top of your game. It also gives you the ability to help people in what can be very difficult circumstances."

It is, however, not something to be undertaken lightly. Cohen adds: "There is a lot involved. If you decide you want to do it, you need to treat it as a profession. While historically a lot of people fell into it by being asked by someone they know, now there are a lot more rules and regulations. It is important you understand the process and are aware of what is required. You are putting your reputation on the line each time and that can have a knock-on effect on you professionally if you do not carry it out properly."

The Academy's information sheet, *Becoming an expert witness*, outlines some of the key qualities required, including: having the right expertise; being authoritative and articulate; being able to work to a tight timetable; and having an understanding of the legal process. However, there are two key issues which anyone considering offering themselves as an expert must appreciate. First, experts have to be independent. While they will generally be appointed by one side, their duty is to the court and, as it is stated in

IMMUNITY UNDONE – TIMELINE OF JONES V KANEY

2001 – Paul Jones is involved in a road traffic accident, later bringing a damages claim for physical and psychiatric injury.

2003 – Solicitors instruct consultant clinical psychologist Dr Sue Kaney to advise and report on the claim. She opines that Jones is suffering from post traumatic stress disorder (PTSD). The psychiatrist appointed by the insurers defending against the claim states Jones is exaggerating the effects of his physical injury.

2005 – The two experts hold discussions to see if agreement can be reached. Their joint subsequent statement reveals Kaney has gone back on previous statements about Jones's condition, agreeing his psychological reaction was just an adjustment reaction, not PTSD, and that Jones had been "deceptive and deceitful in his reporting". The personal injury claim is settled without trial.

Kaney states she had felt pressured to agree to the wording of the document despite feeling it did not represent what she had agreed during the discussion.

2009 – Jones brings a damages claim against Kaney for professional negligence. Kaney applies to strike the claim as it goes against the binding authority of the Court of Appeal's decision in Stanton v Callaghan in 1998 that expert witnesses could not be sued for negligence when preparing a joint statement with the opposing side's expert witness.

The case is leapfrogged to the Supreme Court.

2011 – The Supreme Court abolishes partial immunity for expert witnesses, stating: "Expert witnesses can now be sued for providing negligent expert evidence, just as they could be sued for negligently providing any other service."

Part 35 of the Civil Procedure Rules, which govern expert witnesses, this "overrides any obligation to the person from whom experts have received instructions or by whom they are paid".

Mike Jones FCSI(Hon) was the Chief Executive of private client stockbroker and investment manager Capel-Cure Myers before retiring in 2000. He has since been largely acting as an expert witness in partnership with a colleague. He has appeared in 140 financial and investment cases and says independence is crucial. "On cross-examination, the judge will be looking for any sign of bias." However, he adds that legal advisers will not always make clear to their clients that, although they are paying for the expert advice, the witness will not be taking their side. "At the first meeting [with a client] I will always explain that clearly."

KNOWLEDGE IS KEY

The second key requirement is expertise. That may sound obvious, but very specialist areas will require equally specialist, and up-to-date, advice.

"You are putting your reputation on the line each time and that can have a knock-on effect on you professionally"

Francis Kean, Executive Director, FINEX, at Willis Towers Watson, who has instructed expert witnesses as a solicitor, says: "You would typically only want to be an expert witness if you can genuinely say to yourself and others that you have a long enough track record in the area where advice is being sought. You need, therefore, to be very clear of where, and at what level, your expertise lies.

"Some people are very articulate and experienced at being expert witnesses, are user-friendly and easy to work with. But, when you drill down, you find that their knowledge and experience is not completely relevant or is out of date. Or those with a great knowledge of, and background in, the area do not have the skills required to put the information across in their reports and in court."

In fact, the majority of cases involving expert witnesses do not actually end up in court as they will be settled in advance, although witnesses must always be prepared to give evidence in court as required. Expert witnesses can also be used in arbitration and tribunals. Whatever the eventual venue, however, a key task will be to write an expert report on the issue. Guidelines on what these reports should contain and how to structure them are available through associations like The Academy of Experts and the Expert Witness Institute. Craig Kersey, Chartered FCSI and an experienced expert witness in financial and investment cases, describes report writing as a core skill. "Often you have to be able to communicate very technical information in relatively simple lay terms as well as backing this up with the detail on which your opinion is based."

Kersey, like Jones and many other expert witnesses, got his first case when he was telephoned out of the blue by a lawyer. Both, however, say that training is now essential. "When I think back to my first few cases, I shudder," says Jones. "I did not appreciate what was involved." Now, however, the various professional bodies offer everything from foundation training to courses in more specialist areas.

Both Kersey and Jones have attended a number of training courses and warn of the risks faced when taking on the role unprepared. Kersey explains: "The Civil Procedure Rules represented a paradigm shift in formalising the standards required of experts. I think anyone taking on expert work without undergoing specialist training in the requirements of the role could be putting their future career at risk."

RISK TO REPUTATION

Indeed, being an expert witness does entail risk. While it may be rare, judges can and do criticise expert witnesses. Anyone singled out in this way may find the impact goes well beyond influencing future appointments; it could also affect their professional career and expose them to the threat of being sued for damages. A key case in this respect is Jones v Kaney, which abolished the partial immunity for being sued for negligence (see box), making it more vital than ever that expert witnesses' conduct is impeccable – and that they have professional indemnity insurance cover (available through membership of one of the professional bodies) in case something does go wrong.

While it is possible to combine being an expert witness with a full-time profession, opinions vary on whether this is beneficial. However, Kean warns that by leaving a career completely, expert witnesses may find they become less informed of their industry. He says this can be detrimental for solicitors when it comes to defending their clients.

"You have to be able to communicate very technical information in relatively simple lay terms"

"There is a danger that, after a while, being an expert witness becomes a profession in its own right. But, if they cease to be a practitioner and become a professional expert witness, as they get away from the 'coal face' of their industry, it reduces your ability to defend your client as you ought to."

Kersey, however, points out that, particularly in financial services, there are many reciprocal trading and other relationships between firms. An expert who works at a financial firm may thus face at least the perception of conflicts of interest – and more generalised concerns from their employer over the wider repercussions of the role – which may restrict their ability to take on cases. Jones combines his career as an expert with lecturing to compliance officers and serving on professional bodies, which ensures he is up to date.

The requirements of an expert witness, from client meetings, to report writing, to eventually appearing in court, are time-consuming and may come with very little warning. Those considering appearing as an expert witness need an understanding employer who is willing to allow long absences from work at short notice.

Jones, however, says he would recommend taking up the role. "I have really enjoyed it. I have met amazing people, interacted with the best experts in the country and I test myself all the time." Much of his work has involved misselling cases, where his client may have suffered the loss of much of their life savings. "It is very rewarding to write a report to court which could help them get their money back."

Flying in the face of convention

RIDICULED AT FIRST, LABOUR PARTY LEADER JEREMY CORBYN'S SUGGESTION OF PEOPLE'S QUANTITATIVE EASING IS BEGINNING TO DRAW SUPPORT FROM UNEXPECTED CIRCLES. GREGOR LOGAN, AN INVESTMENT MANAGEMENT PROFESSIONAL AND A MEMBER OF THE *S&IR* EDITORIAL PANEL, EXPLAINS WHY

GREGOR LOGAN

There is a growing list of serious financial figures warning that recent market volatility is correctly anticipating a debt-driven, deflationary global recession. RBS recommended selling everything except government bonds. Albert Edwards, Strategist at Société Générale, is forecasting that the S&P 500 will decline by 75%. William White, former Economic Adviser and Head of the Monetary and Economic Department at the Bank for International Settlements, said the world had used up all of its "macroeconomic ammunition" and would collapse under the weight of accumulated debt. Meanwhile, business magnate George Soros has warned that the European Union is on the verge of collapse.

You might write off these comments as the media-hyped repetitions of 'perma-bears' (investors who consistently act in the expectation that the value of stocks and shares will fall), but they have been joined by more dovish comments from central bankers suggesting the economic outlook is not as robust as the previous month.

Having raised rates by 0.25% in December, with a promise of four more such moves in 2016, the Federal Reserve is now back-pedalling. Mark Carney, Governor of the Bank of England (BoE), has confirmed he no longer thinks the UK economy is strong enough for a rate rise in 2016.

EXPERIENCING TURBULENCE

The world has faced cycles of economic growth and decline for centuries. John Maynard Keynes was one of the most articulate economists to discuss how policymakers should respond to these cycles. He argued for countercyclical government spending during downturns and advocated balancing the books or even running budget surpluses during periods of strong economic growth.

With hindsight, it appears the great failing of government spending decisions in the US, UK and Europe in the period of strong economic growth of the 2000s was to allow growing budget deficits during a period of rapid, debt-fuelled economic expansion. Instead of being prudent in the upturn in order to have something in reserve for the downturn, governments were profligate.

QE has been a force for good in getting economic activity on track, but there have also been unfortunate consequences

Some economists go further and argue that the private-debt-driven speculative bubble of 2007/08 was made worse by this public spending. Whether or not this was true, the results were not limited to vastly inflated commercial bank balance sheets, with assets of dubious quality. As the crisis unfolded, it also resulted in heavily indebted governments with big public sector deficits.

This meant Keynesian countercyclical government spending was not an available policy option. On the contrary, the then new UK Coalition Government controversially deemed it necessary to seek to reduce the deficit in the face of severe recession with their policy of austerity. Central banks responded to the environment of imploding growth that followed by adopting a zero interest rate policy.

When zero interest rates appeared to be insufficient to kick-start their respective economies, and in particular the ability of the commercial banks to lend to customers, they introduced a novel policy termed quantitative easing (QE).

In brief, this involved the central banks creating fiat money (currency that is declared by a government to be legal tender but that is not backed by a physical commodity) to buy in government debt. This drove down interest rates right along the yield curve, but just as importantly, it created an environment in which the banks could rebuild their battered balance sheets.

FLIGHT OF FANCY

QE has clearly been a force for good in getting economic activity back on track, but there have also been unfortunate and mostly unintended consequences, viewed by some politicians as pernicious. The debt burden in western economies is higher now than before the crisis. Speculative activity is evident in many asset classes. Savers have lost out to asset owners and speculators. Institutions such as pension funds, which rely on yields from government bonds, are struggling.

Arguably, the previously untried policy of QE would not have been necessary had the option of increased government borrowing and spending been available as the downturn unfolded. And unfortunately, the legacy after six years of anaemic and patchy recovery is that interest rates remain close to zero, government debts are at all-time highs and central banks still own all of the debt bought through QE. In the case of the UK, the BoE is left with some £375bn of it, which equates to roughly half a year's worth of Government spending.

Why might this matter? Most economists say the simple answer is that it leaves policymakers very short of traditional options in the event of the current market volatility, correctly anticipating another crisis or economic downturn. Should some exogenous shock come along and, for example, burst the bubble in financial markets which then spills over into the real economy, policymakers are left with a dilemma.

They can't cut interest rates, they can't raise government borrowing and yet more QE is going to leave the central banks owning all of the world's government debt. But we should not underestimate the determination of politicians and central bankers to stimulate inflation and growth, and if traditional remedies are no longer available, what new and untried solutions might become politically more acceptable?

GAINING ALTITUDE

When Jeremy Corbyn was elected leader of the Labour Party, he was initially much ridiculed for his suggestion of 'People's QE'. This was a proposed policy of printing money for the Government to invest directly in 'socially beneficial' causes. For example, instead of buying financial assets from commercial banks, People's QE would use the money to fund infrastructure, housing and green energy. The theory is that these investments would be of direct value to the public and lead to higher productivity, which would in turn lead to improved wages, which would then boost the economy. It would not involve buying back existing government debt, and so might have fewer of the perceived pernicious consequences – such as inflating already expensive asset prices – than current QE. The debate would then be a political one about which project or projects would be deemed most deserving. On reflection, his suggestions have been taken more seriously and, should we be faced with another economic downturn, People's QE might become a compelling option.

Milton Friedman, a Nobel Prize winner for economics who was an adviser to former US President Ronald Reagan and former British Prime Minister Margaret Thatcher, famously suggested that there is always one solution to deficient demand in an economy: the government simply prints money and drops it by helicopter.

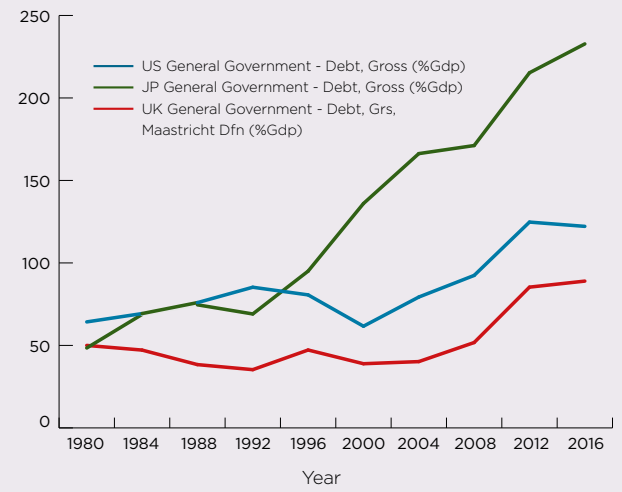
Today it could be done by electronic transfer. A few hundred or a few thousand pounds to everyone and surely some, if not all, would be spent. The difficult bit is deciding how much; too much and you create uncontrollable Zimbabwean-style inflation and a run on your currency. A more radical and equally controversial solution would be a debt write-off. Initially also ridiculed as logistically impossible because of the structure of central bank balance sheets, it too is gaining credibility.

One of the problems with QE is that, while it provides cash for the banks to lend, it cannot force consumers and firms to borrow and spend. So in response, we are beginning to see what might be perceived as a war on cash.

The Bank of Japan has cut its interest rate below zero. That means Japan has made it 'better' for its citizens to spend and not save. It will also cut further "if necessary". Switzerland initiated this policy to combat its strong currency, and has been followed by Sweden, Denmark and the European Central Bank. As with QE, only in time will we really understand both the efficacy of this policy in stimulating growth and, perhaps more importantly, what the unintended consequences might be. The optimists argue that the current volatility in financial markets is just a correction and that the underlying economies are being boosted by lower oil prices, rising wages and employment growth. This should enable a continuation of these economies' anaemic recovery for sufficiently long enough to enable the governments and central banks to re-arm themselves with traditional remedies. In this out-turn we are unlikely to experience and, therefore, learn, the efficacy of helicopter money or People's QE.

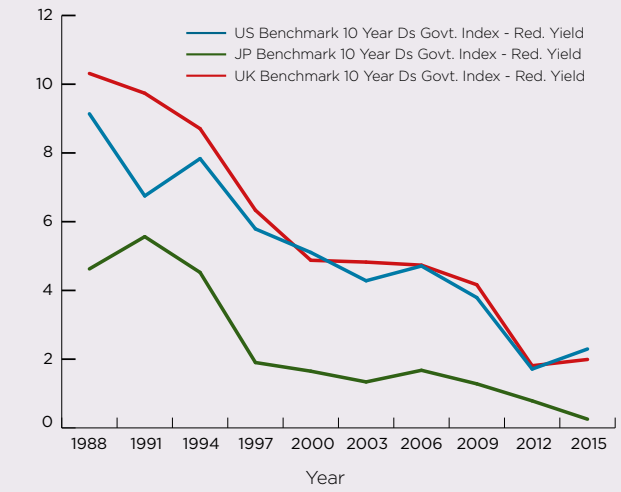
If the perma-bears are proven right, however, we may see Corbyn's idea take flight.

US, JAPAN AND UK GOVERNMENT DEBT TO GDP RATIO



Source: Thomson Reuters Data Stream

US, JAPAN AND UK GOVERNMENT DEFICIT AND BOND YIELDS

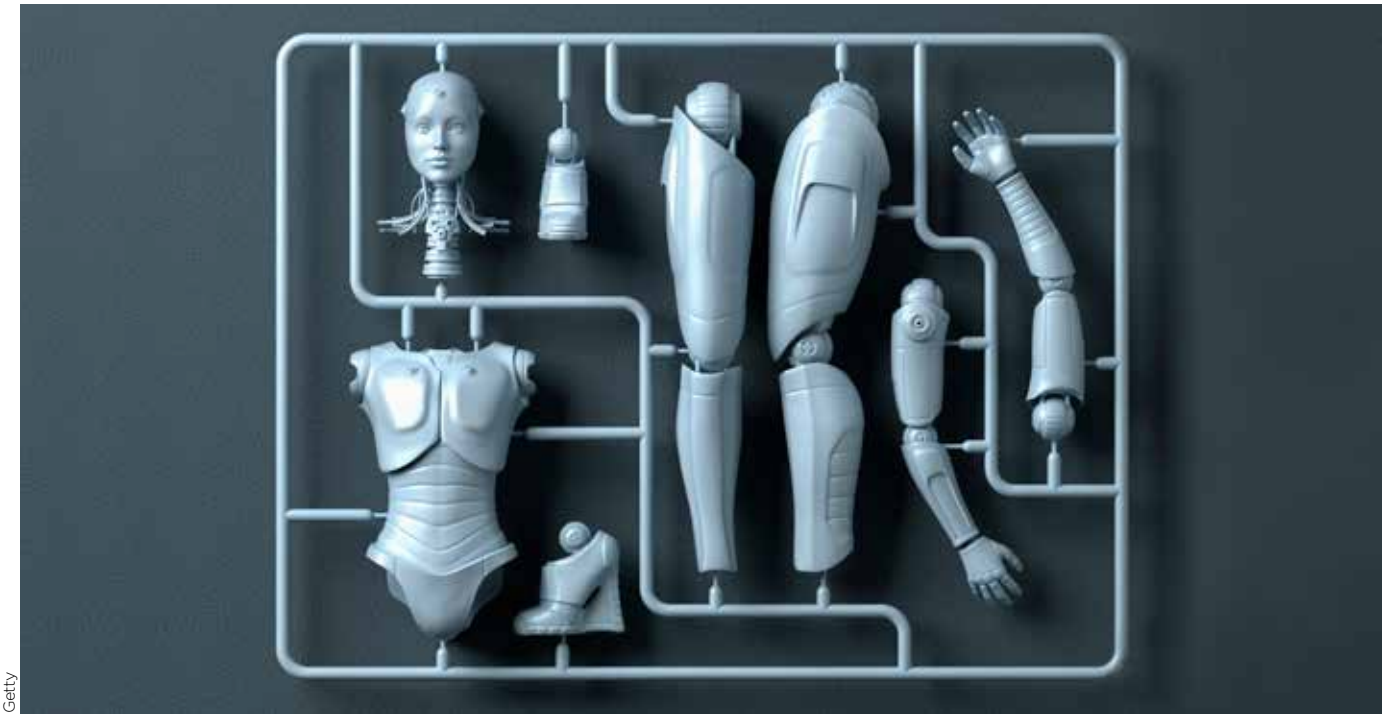


Source: Thomson Reuters Data Stream

Rise of the machines

ARE WEALTH MANAGEMENT ADVISERS REALLY IN DANGER OF BEING REPLACED BY AUTOMATION, OR ARE THEIR ROLES LESS AT RISK THAN OFTEN REPORTED?

HEATHER CONNON



Getty

It is not hard to find predictions of the death of wealth management as a profession. A host of reports from consultants, strategists and even the World Economic Forum warn that an army of 'robo-advisers' – the rather pejorative term for algorithm-based, automatically generated investment portfolios – combined with pressure on fees and the gradual erosion of the traditional long-term relationships between adviser and client, will spell the end for the wealth management industry as we know it. But is automation really the death knell of the industry, or are these doomsday reports greatly exaggerated?

Current statistics suggest there is not that much to worry about. In the UK, Nutmeg is leading the automated advice charge, but analysts at Numis estimate that the online wealth management business had £200–£300m under management at the end of 2014, the most recent figures available.

Is automation really the death knell of the industry or are doomsday reports exaggerated?

In December 2015 alone, total retail sales for the industry were £1.9bn and total funds under management at the end of 2015 were £871bn, according to the Investment Association. In the US, where robo-advice has been around for five to ten years, Numis estimates that assets under management are valued at less than $20bn from an industry total of more than $14,500bn.

TOO SOON TO WORRY

While a number of other companies are now targeting this market, Numis analyst David McCann is sceptical that a significant breakthrough is imminent. He recently attended a conference with presentations from a number of new companies in this area and said: "None of the start-ups in our view managed to convince us that they have yet found a way to overcome consumer inertia, lack of trust/brand name (important when it is your life savings) and lack of understanding of the idea (will people trust a significant

part of their life savings to a new idea?), other than to say that this will come with demographic change (ie, attract small, young customers now that will grow as they get older/richer)."

Nor do fees appear to be under much pressure. Numis compiles a regular analysis of charges by the leading wealth managers in the industry; which shows most charging 2–3% of funds under management – pretty much unchanged over the last decade, despite volatile returns and low inflation.

FUTURE PROOFING

There is not yet much evidence that clients are looking to rush to automation. Research by ComPeer, which benchmarks wealth management companies, found that two-thirds of people aged over 50 chose a face-to-face meeting as their preferred method of getting financial advice; even among younger people, the proportion was only slightly lower at 58%, while just 5% in the younger category and 1% in the older plumped for an online service. The survey also showed little enthusiasm for mobile apps, with only a quarter of those whose firm gave access to one actually ever using it.

"We see it as the use of digital capability to take out the mundane, routine tasks"

Five years ago, however, few of us could have imagined sharing our views on Twitter, our photos on Instagram, our videos on YouTube, our vital statistics on Tinder, or using our mobiles to pay for our groceries. The one certain thing about technology is its ability to affect change. Some of the largest wealth managers are showing an interest in automated advice: BlackRock bought FutureAdvisor; Aberdeen Asset Management has acquired Parmenion; Brewin Dolphin has launched BrewinsDirect; Hargreaves Lansdown launched Portfolio+; BestInvest has a ready-made portfolio and LV acquired Wealth Wizards. While some of these may fail to get off the ground, the very pace of activity increases the chances of at least one automated wealth management service achieving mass-market acceptance.

Janine Menasakanian, who heads up the relationship with wealth managers and banks at Vanguard, the low-cost fund provider, surveyed the industry at a recent seminar and found a fairly even split between those who saw it as an opportunity and a threat. She thinks there is no clear understanding of what the term robo-adviser means. Vanguard has launched its own service in the US, which Menasakanian says will remove some of the more tedious jobs that come with a career in wealth management. "We see it as the use of digital capability to take out the mundane routine tasks in giving advice and helping with decision making."

She thinks the industry will end up using a hybrid of face-to-face and automated advice, tailored to the stage in the life cycle clients are at. "As we accumulate wealth in our 30s and 40s, we probably do not need someone there to tell us what to do – we need a good plan, some goals, and to keep saving. But, as our affairs get increasingly complicated – say we are close to retirement or doing inheritance planning – we will increasingly need face-to-face advice."

STAYING AHEAD

There are two key risks, however. The first is that clients adapt to technology more rapidly than expected and wealth managers fail to keep up. Numis' McCann points out that this was exactly what happened in the 1990s, when the traditional stockbrokers failed to recognise the growing client interest in execution-only business and, although they were well-placed to take advantage of this: "None of the big incumbent players did so in a major way, or those that had execution-only operations neglected them." He thinks most stockbrokers viewed this as a "fad that wouldn't last" and they did not want to cannibalise their business, or put pressure on margins. "Most companies at the time were, in our view, far more interested in capturing share in the high net worth segments of the market. This effectively allowed newer entrants like Hargreaves Lansdown to enter the market relatively unencumbered and ultimately take significant share of industry assets."

The second is that, assuming robo-advisers take on some of the more basic elements of financial planning, it encourages clients to focus on costs – and to discover that their bespoke wealth management services come with a significant cost. Numis' fees analysis shows that the average execution-only platform costs around 1%, Nutmeg's automated offering costs just 0.69%, while most discretionary wealth managers charge at least 2%. With some in the industry already struggling to keep profits growing amid volatile markets, low inflation and competition from platforms, these fat margins could come under pressure.

Frank Dolan, Chartered FCSI and Chairman of the CISI Wealth Management Professional Forum, thinks the industry "does need to raise its game. It needs to become far more interested in financial planning, even at its most basic level", instead of simply offering investment products to produce a specified return. He adds that wealth managers also need to move down the wealth scale, offering services to people with smaller sums to invest – a group which is currently underserved by the wealth management industry.

He admits, however, that regulation and its associated costs can be a handicap in this respect – and, indeed, the Financial Conduct Authority (FCA) has yet to make it clear exactly how it will regulate any automated advice services. The UK Government is keen to encourage these, to help close the 'wealth gap' for people with only small amounts to invest, and the FCA has established what it calls a 'sandbox' for firms to test out new ideas.

"As our affairs get increasingly complicated we will need face-to-face advice"

But Numis' McCann thinks they are still not doing enough to clarify the position – it is, for example, up for debate whether automated services are offering advice or not.

"The regulators are frustrating the industry," he says. "On the one hand, their public statements seem to encourage industry innovation and robo-advice specifically. On the other hand, the continued ambiguity and inaction as to where the boundaries are between advice and non-advice, and if there ever can be a middle ground, is not conducive to anything other than modest investment and innovation."

Getty

Herding cats

IMAGINE THE SCENARIO. IN A ROOM FULL OF INVESTORS, PANIC ENSUES ACROSS THE FINANCIAL MARKETS. WHAT HAPPENS WHEN THEY ALL ATTEMPT TO EXIT THEIR INVESTMENT STRATEGIES AND HEAD FOR THE METAPHORIC CAT FLAP AT THE SAME TIME? BRANDON DAVIES, A BOARD DIRECTOR OF THREE FINANCIAL COMPANIES AND AN ECONOMIST, EXPLAINS THE EFFECTS OF PANIC AND HOW IT MAY BE AVOIDED

The global financial crisis in 2008 marked a watershed for financial markets. It showed that there was very little understanding of how markets functioned when lots of investors wanted to exit their investment portfolios at the same time.

The lack of liquidity highlighted the importance of segmentation, between different individual assets within a market or indeed between different markets. Systemic risk manifested itself as 'correlations all converged to one'. Liquidity, like herding cats, became an issue because it put downward pressure on asset prices and drove concentration in asset correlations. There was significant turbulence in the financial markets in the summers of 2011 and 2013, and more recently in December 2015, when the Federal Reserve in the US hiked up interest rates for the first time since 2008, from 0.25% to 0.5%, with the indication that it could increase rates a further three times in 2016.

Jim O'Sullivan, Chief US Economist at High Frequency Economics, said of the most recent hike: "Equities could go up or down based on history, although my guess is that Fed tightening is at least a bit of a negative for equities."

HOW WRONG CAN YOU BE?

The Fed action was followed by a sudden drop in the value of assets as investors decided to exit their equity investments in unison with global equity markets going into bear market territory in January 2016, with falls of 20%. The drop was in part attributed to fears of an economic slowdown in China, with its dramatic effect on industrial metals prices and with oil prices declining to 2003 levels, causing

a rapid slowdown in investment in US tightly held oil.

So why did this happen? Listening to a string of economists rationalising the situation at the World Economic Forum in January this year, you would think that anyone should have seen it coming. The fact that they did not paints a fairly damning picture of the capability of economists to forecast asset prices and, above all, indicates how little we understand about how markets function. This is particularly disappointing in the light of the history of markets.

THE 2013 'TAPER TANTRUM'

We don't even need to look very far back to see a warning. In the summer of 2013, the then Chairman of the Federal Reserve, Ben Bernanke, started to taper off its quantitative easing (QE) programmes and decided to stop buying bonds. This resulted in a surge in volatility that hit global financial markets. Investors poured money out of the bond market and a so-called 'taper tantrum' ensued.

Financial markets acted out. Bond yields surged as investors priced markets for the removal of central bank bond purchases. Further tightening of monetary policy in the US was expected.

The brunt of the tantrum was felt most in emerging markets. It is well appreciated that changes to monetary policy, or even signals of such changes, could affect the world outside the US.

With this warning from near history, market participants should have been prepared

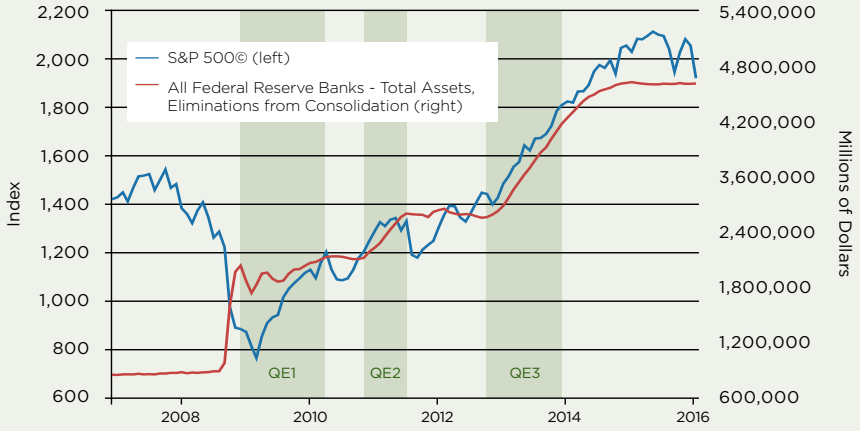
The strength of the markets' reaction was a surprise. This reaction was why, in the aftermath of the taper tantrum, it was considered important to prepare properly for the moment when the Fed would not just talk about raising interest rates, but actually do so.

With this warning from very near history, market participants should have been prepared to absorb the effects of the Fed's action on asset reallocation. This did not happen.

THEORY VERSUS PRACTICE

Classically, markets are there for price discovery. In theory, exchanges bring together investors and issuers of securities to form prices, and market makers provide liquidity to this process by being willing to absorb the sale of securities at around market prices.

THE EFFECT OF QUANTITATIVE EASING ON THE S&P 500 AND FEDERAL RESERVE BANK ASSETS



Source: S&P Dow Jones Indices

But there are several prerequisites required for the process to work. These include:

- The market must be functioning efficiently. The screen price represents a reasonable price for the risks involved.
- The market makers must have sufficient financial capability to absorb the turnover in the market, or be able to place the securities on offer with investors at close to the market price.

There is good reason to suppose that, currently, these conditions do not apply.

CENTRAL BANKS INFLUENCE FINANCIAL MARKETS

While central banks are not considered market agents, their ability to influence asset prices shows that maybe they should be. The graph above maps Fed QE with market prices. It shows the correlation between QE and rising and falling equity prices, and the same principle applies to risky bond prices as well.

QE is a cause of low-cost funding for asset trading. It encourages a shift to high-risk and high-return assets, as well as the ability to hold higher volumes of these assets by geared investors.

Recent and impending reform (the Fundamental Review of the Trading Book) to banking regulation globally has already drastically cut the amount of funds available to market makers that allow them to absorb market trades. They are instead forced to absorb larger amounts of stock to dampen price movements, but are denied the capital to do so.

The herd of cats has increased. There are more of them and they are significantly fatter

For example, US corporate bond markets have grown during the past decade from $2.8tn in outstanding issuance to $5tn. During the same period, market makers' stock positions have fallen from $300m to $60m. The herd of cats has increased. There are more of them and they are significantly fatter, but the cat flap is smaller. Asset price adjustments have become a catfight.

SOLUTIONS

So, while the problem is clear, there are alternative solutions:

- remove central banks from their agency role in markets
- recognise the distorting effects central banks as market agents perform, and attempt to mitigate them.

Removing central banks from this new agency role will clearly take time and would require interest rates to revert back to normal levels.

DIAGRAM 1 – DEFAULT IN MARKET SYSTEM 1 WITH NO INTERCONNECTIONS WITH MARKET SYSTEM 2

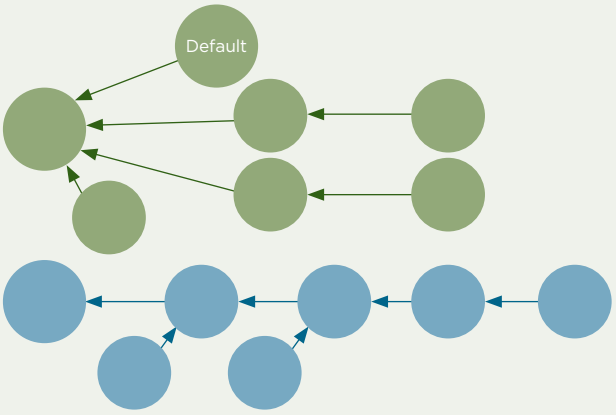
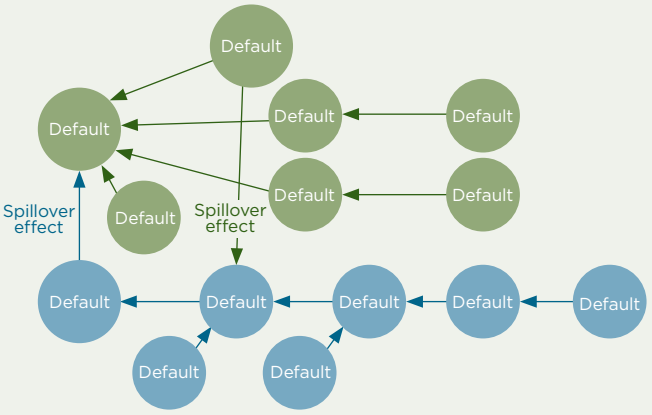


DIAGRAM 2 – DEFAULT IN MARKET SYSTEM 1 WITH TWO INTERCONNECTIONS WITH MARKET SYSTEM 2



However, QE is a vital part of monetary policy for central banks. They are increasingly managing the economy by creating a dislocation between the market clearing rate of interest and their policy rates.

Central banks are also likely to resist this move. The Bank of England (BoE) now has extensive powers to manage separate financial markets through alterations in the regulation of markets to affect pricing without changing interest rates. It seems unlikely it will give up its new agency role any time soon. Mitigating the adverse effects of its new role would seem like a more fruitful way for the BoE to proceed.

However, the most obvious mitigation would be to find a way to get more funds to market makers, allowing them to absorb larger amounts of stock.

This would effectively ensure that more cats can get through the flap. For example, in the US corporate bond market, a proxy could be to set a target for market makers' stock positions of $500m, but this would mean substantial changes to regulation.

An alternative to government intervention could be to restrict gearing by market participants, yet this would likely be easier said than done.

It would mean regulating many different forms of market participant in many different legal jurisdictions. In the longer term, there is the need to understand what is driving markets and how the various market participants relate to each another.

Network theory, the non-linear behaviour of the financial system in situations of stress, is unlikely to be high on the radar of most regulators or market participants, even though the BoE has published a paper on it.

However, it is increasingly being put in the spotlight by researchers looking at systemic risks across markets.

Financial network systems are complex and the interconnections between them are in many instances not well understood, but the importance of network theory can be appreciated from the simple diagrams above. They show how the same default can have a completely different end result, depending on interconnections.

We need to be far more vigilant when looking for catastrophic events

Diagram 1 shows two independent market systems with no connections. A financial institution collapses and there is no contagion in this scenario. On the other hand, Diagram 2 shows what happens in the same circumstances but in this diagram there are just two interconnections between institutions in each market system. The same institution defaults but this now results in all the institutions in both systems collapsing.

HANDLE WITH CARE

So, do we understand how our financial markets are connected? Can we know what effect current changes in regulation are likely to have on the number and extent of these connections? The answer is, of course, no, but understanding this does matter greatly.

When we look at the Lehman Brothers collapse and the seemingly endless reverberations of this on the global economy, it is very clear that the effects are not a direct result of a massive shock, as if Lehman was some Fukushima-like event that overwhelmed the global financial systems defences. It is rather that the network effects of interconnected markets amplified the initial shock and created new shocks that the global financial system was unprepared for.

If this is correct, then we need to be far more vigilant when looking for catastrophic events, as the initial event may well not look catastrophic at all. It is not the event itself that we should focus on, but rather the feedback and feed-forward repercussions and the so-called spillover effects of the event within, and across, different financial markets; something that no individual institution, central bank or otherwise is well set up to understand.

We also need to be very careful in assessing the effects of actions that drain liquidity from markets, as this will drive correlations more closely together.

If it becomes difficult to sell one asset class in a crisis, the inevitable result is that other asset classes are sold, spreading contagion across seemingly independent financial systems. Volatile and highly correlated asset markets are exactly where catfights are likely to break out, as in such circumstances, "the cat that panics first panics best".

WELCOME TO THE *S&IR*'S NEW REGULATORY SECTION: CHANGE

I am delighted to introduce this new section to the readers of *S&IR*. It continues the Institute's coverage of regulation, which up to now has been covered in its magazine *Change*. This served the compliance community, which is a key focus for the CISI but ultimately a minority of the 40,000 CISI members overall. Covering key regulatory changes as a separate section within the *S&IR* will bring them to the attention of members in all roles – not just compliance. The articles below explain to all members why they are significant. In contrast, the more detailed articles on regulation in the online edition of the *S&IR* will be for those who have regulatory responsibilities. In them we will cover the impact of changes on a specific financial sector approximately each month, starting with 'Private wealth management' in April. We will then continue with 'Capital markets', 'Banking', 'Institutional asset management' and 'Derivatives' in the following months so that each of these five areas will be covered twice each year. There will be separate articles on the other sectors covered in Change in the online edition from time to time, and I would welcome regulatory opinion pieces from all members (christopher.bond@cisi.org) on any regulatory topic. I may also ask specific members I meet to contribute these.

I hope very much you will understand that Change – as its name shows – like regulation itself, is constantly evolving and that you will support and enjoy the new approach. I look forward to hearing from you.

Christopher Bond, Chartered MCSI, *Change* Editor

Christopher Bond, Chartered MCSI is Senior Adviser to the CISI. He has extensive experience in financial regulation, both as lawyer and as the Editor of the CISI's well-regarded regulatory magazine, *Change*, which he edited for ten years. He gives presentations on many EU and UK regulatory subjects in the UK and Europe, and writes for a number of regulatory publications. He also supports the CISI's Compliance and European Regulation Forums and advises on Professional Refresher modules. He is a bank board director and Editor of *The International Banker*, the magazine of the Worshipful Company of International Bankers.

Top regulatory developments

Andrew Bailey: the new head of the Financial Conduct Authority

It should be easy to know the priorities of Andrew Bailey, the newly appointed Chief Executive of the Financial Conduct Authority (FCA), from his past 30 years at the Bank of England and the Prudential Regulation Authority (PRA). It is, however, not that easy, since his experience is more in prudential regulation than conduct of business. What is clear is that he knows a lot about regulating banks and sell-side activities, so he now has a lot to find out about the other sectors that the FCA regulates, such as private wealth management and insurance. He may also find it hard to imagine the dynamics of small firms. The strength of character that he has shown in establishing the PRA may be necessary to set the balance between firms and consumers amid overview by politicians, not only the Treasury but also the Commons Treasury Select Committee (see for example the **report**[1] on the effectiveness of the FCA Board commissioned by the Committee which found some weaknesses), which may have made the role seemingly unattractive to some rumoured overseas candidates.

Another approach is to see it as a return to a single regulator, given Mr Bailey's long-term career at the Bank and current role as Deputy Governor there – with all the advantages of co-ordination and disadvantages of conflicting priorities that this produces.

EU reform: the financial services section of the Council's February letter[2]

The wording below is from the February letter from Donald Tusk, President of the European Commission, to David Cameron. To some extent it has been overtaken since it was written by the EU members' agreement negotiated on 20 February, which is based upon it, but with changes.

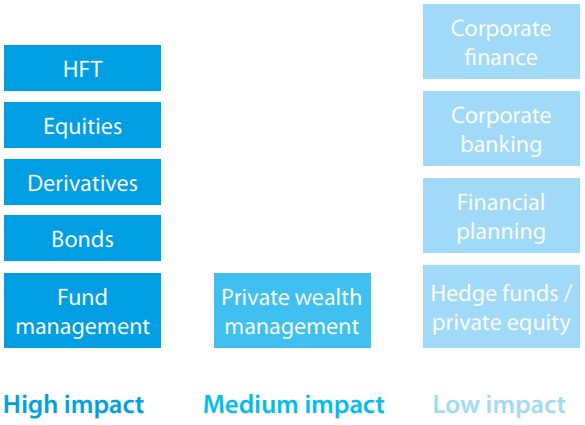
> 1. Legal acts, including intergovernmental agreements between member states, directly linked to the functioning of the euro area shall respect the internal market or economic, social and territorial cohesion, and shall not constitute a barrier to or discrimination in trade between member states. These acts shall respect the competences, rights and obligations of member states whose currency is not the euro.
>
> 2. Member states whose currency is not the euro shall not impede the implementation of legal acts directly linked to the functioning of the euro area and shall refrain from measures which could jeopardise the attainment of the objectives of the economic and monetary union.
>
> 3. Union law on the banking union conferring upon the European Central Bank, the Single Resolution Board or Union bodies exercising similar functions, authority over credit institutions is applicable only to credit institutions located in member states whose currency is the euro or in member states that have concluded with the European Central Bank a close co-operation agreement on prudential supervision, in accordance with relevant EU acquis. Substantive Union law, including the

1. https://www.fca.org.uk/your-fca/documents/reports/fca-board-effectiveness-review-2014
2. http://www.consilium.europa.eu/en/european-council/president/pdf/new-settlement/

single rulebook concerning prudential requirements for credit institutions or other legislative measures to be adopted for the purpose of safeguarding financial stability, may need to be conceived in a more uniform manner when it is to be applied by the European Central Bank in the exercise of its functions of single supervisor, or by the Single Resolution Board or Union bodies exercising similar functions, than when it is to be applied by national authorities of member states that do not take part in the banking union. To this end, different sets of Union rules may have to be adopted in secondary law, thus contributing to financial stability. "

Where are we on MiFID II?

The 'MiFID II monster' is unstoppable. It is delayed until January 2018, since the European Securities and Markets Authority (ESMA), the Commission and the Parliament agree that the original timetable of January 2017 is impracticable, so giving ESMA enough time to make the necessary IT preparations based on its final draft standards, and firms and markets enough time to implement these. Firms could postpone their preparations, but many are proceeding with them, given the time needed for fundamental changes to markets, products and the conduct of business, and the availability of most of the detailed rules in ESMA's draft final standards. There remain important exceptions, for example in the liquidity of bonds, where ESMA's Chairman, Steven Maijoor, recently estimated that only a small fraction of the 54,000 bonds currently admitted to trading would meet the test for the mandatory on platform execution requirement, and on the ban on product providers' payments to distributors.



Firms in different financial sectors will be affected differently by MiFID II changes – see graphic above. Sell-side firms will be most affected – through mandatory on platform execution of liquid bonds and derivatives, by the new pre- and post- price transparency disclosures and by the new classification of firms regularly matching customers' orders with discretion (organised trading facility – OTF) or using their own funds to do so (systematic internaliser – SI), with the consequential duties, eg, OTF price transparency or SI market making.

Although less affected by MiFID II changes, private wealth managers have to make significant changes too, such as in possible changes to the UK product provider's commission ban under the Retail Distribution Review, and in costs disclosure, best execution, record keeping of electronic communications, client reporting, transaction reporting and product distribution **responsibility**.[3]

The Senior Managers Regime

The one immutable change surviving the recent change in banking supervisors' attitudes, is individuals' regulatory responsibilities. The edges of the new regime may have softened, eg, in moving the burden of proof back to the regulator for breaches of regulation in his or her area of responsibility, but the regime is essentially untouched. This has led banks to undertake a huge amount of work in producing the management responsibilities map and the individual statements of responsibility (SoR) and in making the necessary 'grandfathering' applications for existing staff. The regime starts in March for senior managers and certification staff in banks, including some large investment banks. In 2018 the new regime (with some modifications) will apply to all types of firms (replacing the current Approved Persons Regime), so they will need to take notice of how the banks are preparing now. Some difficult issues they have encountered are:

- aligning the responsibilities map with the corporate or group structure
- in the SoR, balancing group or committee decision making with individual responsibility under the SoR (operating by consensus is one solution)
- establishing which overseas head office staff to include as managers (do they have a power of direction over the firm's activities?)
- if decisions are taken at overseas group level but the UK individual is responsible to the regulator, should that person have a right of veto or appeal over the head office's decisions?
- whether the firm's general counsel is a senior manager. The regulators are considering this. Firms are not keen given its likely effect on legal privilege.

Where will the Financial Advice Market Review lead us?

It all seemed straightforward – the Financial Advice Market Review (FAMR) would encourage technology, enabling new services to consumers with less assets and some relaxation of the rules for independent financial advisers (IFAs), reducing their costs and charges. Ideal for the new pensions world. But inevitably it has become a Pandora's box, with different sectors' raised expectations now fiercely debated. Traditional financial planners demand that the human element to advice should be integral; firms using technology to deliver models, allocations and advice see it as an open door to a new world of automated lightly regulated products; private wealth managers have a growing wish list of regulatory liberalisations, particularly on suitability duties, and the consumer lobby both welcomes automated services and fears that they may be too rigid and even dangerous. Meanwhile, banks have moved the debate on by closing the 'advice gap' through re-entering the financial planning and investment advisory markets, either fully (Santander) or on a limited advice basis (HSBC), and new types of technology driven services have multiplied. If the Treasury and FCA's response to the **'call for input'**[4] is delayed beyond the Spring Budget, there is a risk that the landscape will have changed a lot since the questions were originally asked in August and responses made by December 2015.

3. 'Preparing for MiFID II, points for firms to start considering now', Change, May 2015, p.30
4. http://www.fca.org.uk/static/documents/famr-cfi.pdf

In its own **response**[5] to the call for input, the CISI focused on the cost of good quality advice which must be reduced to a level that consumers with fewer assets can afford –first through encouraging advisers to use technology to help (but not replace) them (such as artificial intelligence), and second to encourage advisers to provide advice through reducing the suitability requirements for advice on smaller amounts into less risky investments, reducing the cost to advisers so they can lower their charges. There is also a need for those individuals providing advice to consumers to be suitably competent (including qualified) for the appropriate product or service. This means selecting the right level of knowledge and qualification to take account of the product or service's complexity and riskiness. The CISI applauded the innovative regulatory approach of the FAMR in opening up discussion on having different levels of suitability requirements, and proposes that the same approach should apply to qualification levels.

What is happening with the Fair and Effective Markets Review?

There has been little publicity about progress on the Fair and Effective Markets Review's **(FEMR) recommendations**[6] since they were published in June 2015. However, action is being quietly taken on these big changes for all firms in the Fixed Income, Currency and Commodities (FICC) markets.

- The FICC Market Standards Board under its interim leader, Elizabeth Corley, has started work on clarifying the issues (such as 'last look' and 'stop loss') raised in the FEMR report, and has set up a series of working groups to do so. Many of these issues are now being regarded as generically similar across foreign exchange (FX) and all other FICC products.
- Meanwhile, work continues on the new Code of Conduct for FX – the Bank of England FX Joint Standing Committee, reformed with new Terms of Reference, met on 28 January. Its work focuses on the drafting of the Global Code and the Bank's role of promoting and incentivising adherence. An interim draft will be published in May 2016. The most active banks and interdealer brokers in the global FX market have recently completed their FX remediation and attestation work for the FCA and PRA, which, it is hoped, will help to draw a line under the issues that have damaged the reputation of the FX market in recent years. Much of the work being done in FX will feature in future arrangements for other FICC asset classes.
- Finally, the FCA has responded to the FEMR recommendation that a modified form of the Senior Managers and Certification Regime (SMCR) should apply to FICC employees, through rolling out the regime to all types of firms both inside and outside FICC from 2018 – see 'The Senior Managers Regime', p. 30 for more information.

The Market Abuse Regulation starts soon and will affect you

Overshadowed by MiFID II, the Market Abuse Regulation (MAR) makes big changes to the market abuse regime, which will affect most types of firms (apart from investment research). It starts on 3 July this year, so there is little time to prepare for these. The scope of the regime is widened to cover commodities derivatives, high-frequency trading (HFT), attempted dealing and the new type of trading platform under MiFID II, the organised trading facility (effectively bringing in non-EU listed investments). There are many important new duties on firms as a consequence, such as consistent transaction monitoring (with a bias towards systems), speeding up Suspicious Transaction Reports and market disclosures, changing market sounding and investment recommendation practices, tightening up the regime for managers' transactions and issuers' disclosures, and more detailed record keeping and disclosure requirements. The FCA is currently consulting on market soundings and issuer disclosures.

Firms that have not yet started to prepare for these changes should now do so urgently.

Do you know how the EU Benchmarking Regulation applies to users?

This Regulation goes much further than the current UK rules, which are on the administrators of a few key indices, such as the London interbank offered rate (LIBOR). It applies to any "index or indicator used to price financial contracts or to measure the performance of an investment fund", whether the index is EU or non-EU, such as the S&P 500 – the emphasis is on how the index is used. Although most of the new requirements will apply to the submitters and administrators of benchmarks, users – such as funds or even wealth managers – are subject to the new requirement not to use an index or benchmark for which the administrator has not been authorised (if in the EU) or recognised as subject to equivalent regulation if outside it. Procedurally, therefore, it is up to the administrator to apply for this approval or recognition, failing which the fund or portfolio manager cannot use it. This has led to considerable concerns among managers that they will be restricted in their choice of benchmarks, because non-EU administrators may not apply. These apply equally to EU benchmarks – indeed a number of leading providers, such as Barclays and HSBC, have not liked their new onerous duties as administrators, and have either outsourced or sold their benchmarks. This has led to competition concerns as the number of suppliers shrinks and barriers to new ones increase. Regulators have tried to soothe these concerns through requiring providers to give fair access to benchmarks, but many firms worry that they will have to pay high royalties to use those that are available.

The Regulation is likely to be implemented towards the end of 2017, after ESMA has made the detailed level 2 standards. Firms are encouraged to become involved in making these now.

Can you 'buy-out' a new joiner's lost bonus shares?

The PRA is **consulting**[7] on changing the Remuneration Code to restrict a firm's ability to 'buy out' the variable remuneration of a new employee's deferred bonus award that the old employer has cancelled. The options are: banning buy-outs; requiring firms to maintain unvested awards when employees leave a firm; applying malus to bought-out awards; and relying on the existing clawback rules. The PRA is concerned about the practical difficulties of the first two, and favours the third approach (applying malus to bought out awards). Currently this new rule will only apply to material risk takers in Remuneration Code Tier 1 and 2 firms. In future, under the European Banking Authority's (EBA) extension of the Code to Tier 3 firms, this restriction will apply to all Code firms.

5. http://www.cisi.org/cisiweb2/cisi-news/s-i-review-article/response-to-the-treasury-fca-financial-advice-markets-review's-call-for-input
6. http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf
7. http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp216.pdf

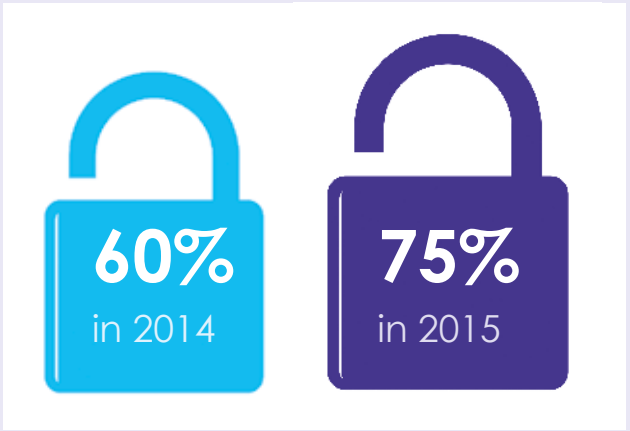
What's new in supervision and enforcement?

Quite a lot. Here are some highlights:

- Research by the archiving and compliance firm Smarsh into what email and instant messages the FCA expects firms to keep has shown that 69% were asked to show email records, 39% telephone call logs and recordings and 36% instant messages sent to clients or chats via websites. MiFID II will extend both the scope (eg, mobiles) and period (eg, five years) for records.
- There is an important **speech**[8] by Jamie Symington, Director in Enforcement on internal investigations into problems by firms. This describes when the FCA approves of them as not prejudicing its own enquiries, and what the firm can do to encourage reliance upon those investigations, eg, the degree of independence and discussing the scope with the FCA in advance, and the problem of what documents from the internal investigation to disclose to it and in civil court proceedings brought by customers.
- The FCA has given a useful **description**[9] of when it will use its restriction and suspension powers for firms' regulated activities. This is primarily to deter where it is more effective as a disciplinary step. Examples given are preventing a firm appointing Appointed Representatives and from taking on new customers.
- The PRA has begun to use financial penalties as a disciplinary tool. In one case it fined a **private bank**[10] for failing to oversee a key outsourcer through giving it authority to move customers' funds; in another case an individual **firm owner**[11] for diverting insurance premiums leaving the insured without cover.
- The saga of complaints about the FCA including reasons in final notices agreed with the firm that indirectly identify a person, which that person has no opportunity to contest, continues. The Upper Tribunal test is whether the person is able to satisfy it that any of the words would reasonably lead persons acquainted with the person, who operates in that financial services industry sector, to believe that he is prejudicially affected by those notices. Decisions have gone both ways.

Many financial crime developments

- The **Fourth Money Laundering Directive (MLD4)**[12] is coming. All countries, including the UK, must implement it by June 2017, and the UK may do so earlier because of the Financial Action Task Force's (FATF) international inspection of the UK in 2016. The FCA plans to consult upon its implementation this spring. MLD4 makes some big changes, including moving the focus to risk, with less emphasis on fixed procedures; the expansion of the politically exposed person (PEP) regime to domestic PEPs, including tax crimes; and for companies to record the identity of beneficial shareholders of 25% or more. UK firms' duties under the UK's Money Laundering Regulations will change.



How many small businesses had a malicious security incident?

Source: PwC's 2015 Information security breaches survey

- Some subsidiaries of US and Japanese firms have been asked to adopt global group financial crime policies. These are normally drafted for the parent company's jurisdiction rules, and can cause considerable practical difficulties when applied outside, eg, in the UK. There are particular problems with obtaining new information from existing clients.
- Transparency International has **assessed**[13] the UK's anti money laundering regime and found serious weaknesses. For example, a third of banks dismissed serious money laundering allegations about customers without adequate review. While the financial sector has done well in producing Suspicious Activity Reports, there are persistent problems with compliance and awareness of how to make effective decisions.
- The US and the EU are considering new laws that will penalise businesses that fail to take measures to protect individuals' data from hacking. This was highlighted in the attack on Talk Talk, where the losses may be as high as £60m. The problem appears to be particularly acute in smaller businesses. Alarmingly, only a small fraction of the IT spend is used for it, and a substantial minority do not train their staff to prevent it.
- Checking for customers or counterparties which may be on a sanctions list is becoming increasingly tortuous, given the differences in the lists maintained in different jurisdictions. For example, Iranian sanctions have been eased at different speeds. In theory, a UK firm should look only at UK sanctions, but that is not the reality for many UK firms, as Deutsche Bank has become the latest firm to find out in the US. Outsource providers' data is often valuable but may not be complete.

8. https://www.fca.org.uk/news/speeches/internal-investigations-by-firms-
9. https://www.fca.org.uk/your-fca/documents/regulation-round-up/rru-november-2015
10. http://www.bankofengland.co.uk/pra/Documents/supervision/enforcementnotices/en271115.pdf
11. https://www.fca.org.uk/your-fca/documents/final-notices/2016/shay-jacob-reches
12. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32015L0849
13. http://www.transparency.org.uk/wp-content/plugins/download-attachments/includes/download.php?id=4398

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REVIEW OF FINANCIAL MARKETS

RESEARCH INTO WEALTH MANAGEMENT, CAPITAL MARKETS AND BANKING ISSUE 9 MARCH 2016

CONTENTS

This spring edition of the *Review of Financial Markets* (*RoFM*) features four contributions from specialists who straddle finance and academia – and the criminal world. A feature of the best business schools and universities in Britain and elsewhere is their close connection with the industries and professions they serve, to help share experiences and extend knowledge. Close co-operation between these groups generates insights and inspires ideas that modern financial businesses welcome. We hope this edition opens doors to some of that fresh thinking. There are no formulae in this issue; instead a deep dive into live, up-to-date research and data, and penetrating analysis, focused on practitioners' interests and straddling our various professional areas – capital markets, financial planning, fintech and operations, risk and compliance, wealth management and of course integrity.

Dr Hatim El-Tahir of Deloitte and Henley Business School kicks off with a peek into the outcomes of a big research project he conducted through 2015, with the help of CISI members worldwide and others, into the changing face of Islamic finance. The success of the UK sovereign sukuk in 2014 – analysed in our online *Securities & Investment Review* (*S&IR*) in January – gave fresh wind to an industry already under pretty full sail. The potential corporate market for sukuk in the west is substantial, a welcome addition in both buy and sell-side armouries. Dr El-Tahir's detailed analysis of his large pool of data shows the potential for bringing investment funds from the Muslim world – still vast despite the oil price slide and current market conditions – together with funding needs in the world at large, from European mid-corporates to major infrastructure projects. It's not just Britain which is joining this journey; other pretty secular countries, like Russia and its former Soviet neighbours, and Turkey are turning to Islamic finance as market conditions tighten.

Of all the CISI's acclaimed series of *Professional Refreshers* (online continuing professional development courses) the money laundering module beats its excellent rivals by a country mile each month in terms of member take-up. Kenneth Murray, author of the second piece in this issue, is a Chartered Accountant, at the front end of policing in Scotland, a country with long-standing problems with organised crime and related money laundering activity. For eight years, Mr Murray was with the Institute of Chartered Accountants of Scotland, as Assistant Director, Legal Services, providing a forensic accountancy capability to its investigation and discipline functions. He joined the Scottish Crime and Drugs Enforcement Agency as Head of Forensic Accountancy in May 2007, and was appointed to the same role for Police Scotland in March 2013. He is the author of a number of published papers in the academic press and has recently completed extensive work for the European Monitoring Centre for Drugs and Drug Addiction on Organised Business Structures and Processes in the criminal world, a theme which he will be developing in his next article for *RoFM* as well as at a CPD event for the CISI in London in May. (He speaks of course for himself, and not for Police Scotland, in this paper.)

Daniel Broby, author of the third article, worked in the fund management industry for 30 years, holding a number of 'C' level positions at leading fund managers. His career involved working a number of different centres, including London, Copenhagen and Moscow, where he developed a strong focus on emerging markets. He is now Director of the Centre for Financial Regulation and Innovation at Strathclyde Business School in Glasgow. The crises of recent years, he points out, were in large part the result of regulatory failure to embrace the innovations that had evolved from academic research in finance. The regulatory responses to these market shocks, while in many cases welcome, were nonetheless based on scant research into the likely outcomes, particularly the impact on capital markets. That will be one of the chief focuses of the work of the Centre. It will be bringing empirical evaluation and robust testing to bear on the new regulatory models.

The final contribution is the result of a project incubated at the London School of Economics by Roger McCormick, a Visiting Professor at the School, and Chris Stears, Chartered MCSI, who have taken an ongoing analysis of the cost of conduct failures at big global banks to new heights – or depths. The numbers – see page 44 – are frightening. This duo know their stuff. Professor McCormick was formerly in the thick of City legal practice at Freshfields; Mr Stears, a lawyer and regulatory consultant, has been closely involved for some years with, inter alia, the Cambridge International Symposium on Economic Crime. At a recent CPD event* (available on CISI TV) they made the point that "the recent conduct cost phenomenon draws out the need to think beyond the traditional notions of conduct risk management to take true account of the prudential and regulatory risk implications, while developing systems and controls that leverage risk management experience to inform and approve strategy, conduct and culture". Failure to do so, they pointed out, raises both the conduct and regulatory risk inherent in operations, and as the Financial Conduct Authority (FCA) has noted: "Culture change within firms is essential if we are to restore trust and integrity to the financial sector, and the FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interest of their customers."

This 'recalibration' of cultural and behavioural standards has seen banks espouse 'values' statements and engage conduct risk management professionals, who invariably cite the usual 'best practice'. However, the senior management rhetoric is not translating into learned conduct risk management practice.

Forthcoming research roundtables

In March, the CISI will start a series of roundtables with major universities and business schools around Britain. These will provide an opportunity for members to delve into relevant research currently underway. The events will give researchers in these institutions the opportunity to meet their professional peers, to help shape their research and possibly gain access to unique data for mutual benefit. The first of these will be held in Scotland on 16 March 2016 at Strathclyde Business School and 17 March at University of Edinburgh Business School. The first London roundtable will be held at Cass Business School in April. We look forward to welcoming members at these events, which are linked in each case to our programme of integrity workshops for undergraduate and postgraduate students at these institutions. Full details on the CISI website events page.

Enjoy the issue, and please give us your feedback.

Guest Editor George Littlejohn MCSI, Senior Adviser to the CISI

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* 'The cost of trust gone wrong – $300bn and counting'

CORPORATE SUKUK IN EUROPE: ALTERNATIVE FINANCING FOR INVESTMENT PROJECTS

Dr Hatim El-Tahir, Leader of Deloitte's Middle East Islamic Finance Knowledge Centre (IFKC), Manama, and Associate Professor of Finance at Henley Business School, Reading

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INTRODUCTION BY GEORGE LITTLEJOHN MCSI

During 2015, Dr Hatim El-Tahir conducted a major global survey on the appetite for 'euro sukuk' amongst CISI members and others. His research partners, apart from the CISI, included Henley Business School, with which the Institute is engaged in a master's programme on financial regulation with the UK's Financial Conduct Authority, and the International Centre for Education in Islamic Finance (INCEIF).

The results were presented at a CISI event in London on 30 November 2015, featuring almost 30 speakers from the United States, Europe, the Middle East and Asia. INCEIF's head, Daud Vicary Abdullah, for instance, flew from his headquarters in Kuala Lumpur to be with us. We are delighted to give this important research the airing it deserves. For full details of the research results and the project of which it forms part, please email Dr Hatim directly (details above).

EXECUTIVE SUMMARY

Industry policy makers and regulators continue to keep pace with global regulatory and financial markets development, providing the required support for the industry's sustainable growth. The Islamic capital market is uniquely advantaged in the current climate to create innovative Sharia-compliant debt and equity instruments that will address the increased demand for funding infrastructure projects in both developing and maturing economies. Currently, developing countries spend about $1tn a year on infrastructure, and an additional $1–1.5tn will be needed through 2020 in areas such as water, power and transportation projects, according to the World Bank.

This industry study assesses the demand and supply – in European markets – for an alternative financing instrument that will stimulate economic growth and cross-border investment. There is arguably a reciprocal need of European corporates to finance infrastructure and investment projects, caused by scarce debt finance for long-term, generally high level of upfront capital infrastructure projects. There is also a need from Middle Eastern and Asian investors for Sharia-complaint assets in maturing economies that are often in time not economically correlated, eg, Europe.

The study provides empirical analysis of matching these two needs between historically interdependent trade and investment economies – the Middle East and Asia (MEA) and Europe.

THREE TRENDS EMERGING:

- Governments in several European jurisdictions are attempting to provide level playing fields for Islamic finance practice. Some have gone a long way, such as the UK, Luxembourg and Ireland. Others are striving to match regulatory developments in these countries and have provided good breakthroughs in changing national regulatory frameworks to host the industry, in particular, Turkey, Germany, Italy and possibly Spain, and to some degree France.
- Constrained professional and industry dialogue between corporate professionals and investment bankers, widening knowledge and awareness gaps of Islamic finance amongst the market players.
- The observational analysis enforces good market sentiment amongst practitioners and market players. The general perception is optimism for great growth in this market in the next few years, depending on global market conditions improvement.

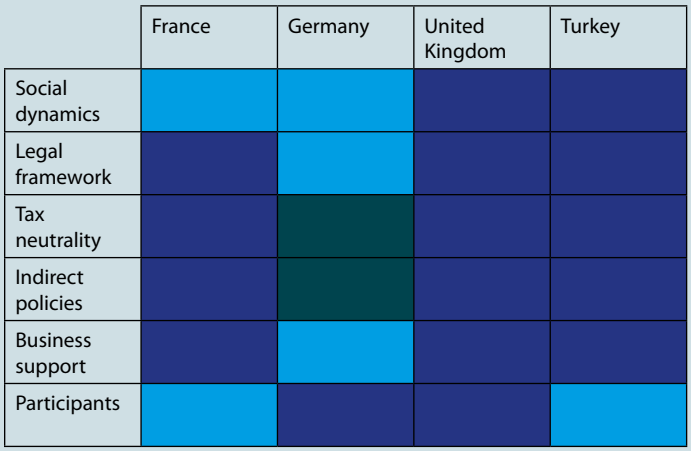
THE SURVEY'S KEY FINDINGS REVEAL THAT:

- 91% of respondents have considered ethical investments in sukuk
- 68% of respondents would consider sukuk, and another 24% might consider the instrument depending on its merits if the transaction entailed any tax benefits
- The majority of respondents prefer equity followed by sukuk over all other proposed asset categories
- Stakeholders are more likely to dedicate a smaller percentage bracket of their capex to sukuk
- 81% of participants prefer to invest in USD-denominated sukuk
- 75% of respondents would still consider investing in sukuk even with lower/similar yields than other bonds
- 55% of respondents would definitely consider sukuk as a tool to reduce risk and diversify their portfolio, with another speculative 34%.

TAX, REGULATORY AND POLICY ENVIRONMENT – CROSS COUNTRY EXPERIENCES: FRANCE, GERMANY, THE UK AND TURKEY

The participation of each industry stakeholder plays a crucial role in developing an ecosystem required to build confidence in both potential sukuk issuers and investors. The study has found that the UK is leading the implementation of initiatives to encourage the growth of Islamic finance and the issuance of sukuk in the country.

The study looks at various indicators, such as social dynamics, an economic and regulatory review, and a participating stakeholder's review to gauge the current climate and potential in moving forward.



SOCIAL DYNAMIC

The social fabric of different societies is gradually being redrawn with globalisation and the migration of people seeking better job prospects in developed nations. While Muslims constitute a minority group in France, Germany, and the UK, there is growing demand for Sharia-compliant goods and financial services, such as halal food and beverages, and investments in industries that are not related to gambling, alcohol, pornography, entertainment and pork.

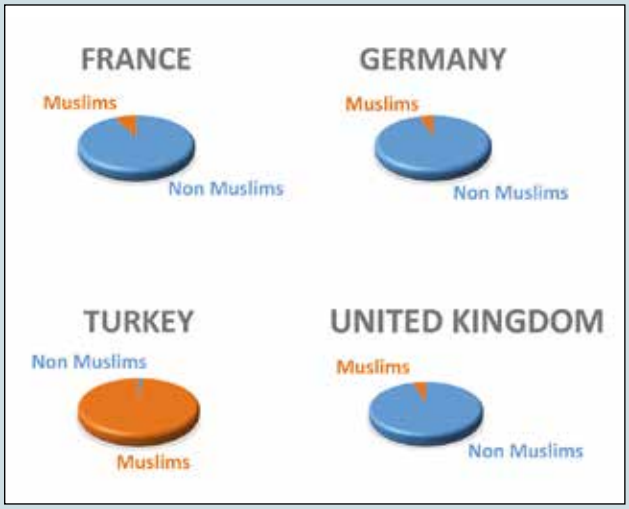
TURKEY

With the majority of the population being Muslim, it was expected that the development of Islamic finance in Turkey would be largely driven by local demand. However, this was not the case given the sensitivities of developing the industry in the secular republic prior to 2012. The tide changed after 2012, when the Turkish Government introduced Islamic finance, through the issue of Turkey's first sovereign sukuk.

FRANCE, GERMANY, AND THE UNITED KINGDOM

There are approximately four to five million Muslims residing in each of these three countries. This creates a reasonable mass for Islamic finance in areas of retail, corporate and the small and medium-sized enterprises (SME) landscape, all of which could help grow corporate sukuk issues in these countries.

THE MUSLIM POPULATION IN EUROPE



Key findings

While demography may determine the broad acceptance of Islamic finance within the country, it will not be the core determinant of interest by foreign investors in these countries. Luxembourg and Ireland are examples of European countries with similar demographics to France, Germany, and the UK, and these two countries have made progressive developments in the industry, with favourable banking regulations and government-initiated policies.

Countries that have a Muslim majority population (such as Turkey), may find that a Muslim majority could work as a double-edged sword as the general population leans towards secularism. This slows down progress in the development of Islamic finance.

ECONOMIC AND REGULATORY REVIEW

LEGAL FRAMEWORK

Establishing a comprehensive and effective legal framework secures the enforceability of Islamic finance contracts and ensures that there is an effective legal process for dispute resolution. Precedent sukuk default cases have highlighted disputes across different jurisdictions on the rights given to investors of special purpose vehicles (SPVs), a structure heavily utilised in Islamic finance contracts.

France

- Supervisory body: Autorité des marchés financiers (AMF)
- Legal framework was modified in 2009 to allow banks and private issuers to sell sukuk
- Clear guidelines for sukuk issuance, drafting sukuk prospectuses, and obtaining approval for listing on French regulated market
- Provision of advice to sukuk issuers throughout the listing process to ensure compliance with EU Prospectus Directive.
- Established co-operation with Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI) to develop amendments to French law to accommodate Islamic finance.

Germany

- Supervisory body: Federal Financial Supervisory Authority (BaFin)
- There are clear guidelines on bank license
- Requirements for Islamic financial instituitions under the German Banking Act
- Issued a banking license to a foreign bank (Kuveyt Türk Beteiligungsbank) to conduct limited Islamic banking operations in Germany
- Actively held conferences on Islamic finance since 2009.

Turkey

- Supervisory body: Capital Markets Board of Turkey (CMB)
- Legal framework was modified in 2013 to permit the use of diversified Islamic financial instruments in Turkey, enabling sukuk that are structured using Istisna', Murabaha, Mudaraba, Musharaka, and Wakala
- Issued clear guidelines, principles, and legal framework for lease certificates (Ijarah), special purpose vehicles, and sukuk Ijarah.

UK

- Supervisory bodies: Financial Conduct Authority (FCA); Prudential Regulation Authority (PRA); the Bank of England, and the Government (HM Treasury)
- Legislative measures introduced to establish a level playing field for Islamic and conventional instruments and to enable UK companies to issue a range of Islamic financial products. Any inequality is swiftly remediated through revisions in the legislation and regulations.

Comparison with other European countries with established Sharia practices

Ireland
Supervisory body: Central Bank

- Established a Sharia Funds Specialist Unit to assist with regulatory applications involving Sharia funds
- Sharia element is viewed as a 'socially responsible' investment element
- Sharia-compliant funds domiciled in Ireland
- Accommodated within the existing tax framework
- Entitled to the same favourable tax treatment offered to conventional funds (such as zero tax on fund's income or gains, no stamp duty, and zero withholding tax on distributions to non-Irish residents)
- Enjoy equal tax treatment for Islamic financial instruments and similar reporting obligations as conventional funds.

Ireland is home to two industries that are Sharia compliant and have the potential of boosting the sukuk liquidity pool

- Renewables and clean tech industry
  - Identified by the government as a key industry for development
  - Incentives for companies to realise inherent value from 'carbon offset' qualifying assets
- Aircraft leasing industry
  - One of the oldest and longest established international financial services industries in Ireland.

Luxembourg
Supervisory body: Commission de Surveillance du Secteur Financier (CSSF)

- Regulation issued in 2011 to clarify the tax rules and listing requirements for Islamic financial instruments
- There are no specific legal requirements concerning Sharia investment funds set up under the Luxembourg law
- Treatment of sukuk and remuneration of sukuk is similar to conventional debt and interest
- Payments on sukuk are not subject to withholding tax
- The direct and indirect tax authorities have also issued clarifications on the major principals of Islamic finance, direct tax treatment, and indirect tax treatment of Murabaha and Ijarah contracts.

Luxembourg has marketed itself not just as a prime location for setting up and servicing conventional funds, but also Islamic funds.

The Association of the Luxembourg Fund Industry and Luxembourg for Finance have put together brochures to provide comprehensive information on the legal framework and tax treatment for a range of commonly used Islamic finance structures, as well as best practice guidance for investors.

TAX NEUTRALITY

Amendments to tax laws, in order to establish tax neutrality for Islamic finance transactions and instruments, create a level playing field between conventional and Islamic financial products. Inequality of tax treatment arises in Islamic finance transactions due to a sale or exchange of the underlying asset to the SPVs, triggering capital gains, stamp duty, and withholding income taxes depending on where the asset owner is located in a foreign jurisdiction. Providing tax incentives could reduce the hidden costs of issuing sukuk and encourage more enterprises to issue or invest in them.

Analysed countries					Comparison with other established financial markets	
Country	France	Germany	United Kingdom	Turkey	Ireland	Luxembourg
Tax neutrality	Yes	No	Yes	Yes	Yes	Yes

Key findings

Having the first mover advantage into the European sukuk market, the Saxony Anhalt (Germany) state's sukuk issue in 2004 did not automatically translate into Germany becoming a leader in the European sukuk market. With no tax neutrality or favourable government policies subsequent to the maiden sukuk issue, corporate sukuk issuance is more concentrated on foreign companies that are keen on tapping into the deep liquidity in the German financial markets, rather than from local medium sized companies.

Developments appear more promising in France, the UK and Turkey, where there are regulations and infrastructures in place to promote the issuance of sukuk. However, guidance provided in Turkey is limited to sukuk based on Ijarah (lease certificates). Despite the limitations, the Turkish Government's open support to develop the country's Islamic finance sector and sovereign sukuk issuance serves as a promising factor.

OTHER PARTICIPATING STAKEHOLDERS REVIEW

Indirect policies

Implementation of policies to encourage the development of identified industry sectors, growth of local companies, or socially responsible investments can be strategic for the development of Islamic finance. The governments of France, the UK and Turkey have implemented several schemes which have synergies with the development of corporate sukuk.

Socially responsible investment (SRI) scheme

- The French Government's active support for initiatives that develop social and environmental transparency of business
- Requirement for compulsory annual non-financial reporting on social, environmental and societal criteria for businesses whose shares are traded on a regulated market.

EXPLORING THE POTENTIAL OF THE FRENCH SRI SCHEME

Given the parallels that can be drawn between SRI and Sharia-compliant products, France's emphasis on SRI culture is strategic for potential growth of the sukuk market in France.

Examples of socially responsible investments include green bonds, which are debt instruments issued to raise financing for projects that generate direct environmental benefits (such as renewable energy, social housing, education).

Green tax systems

- France, Germany and the UK have in place green tax systems to encourage green innovation and achieve energy efficiency. The incentives to develop green innovation comes in various forms, such as:
  - Tax incentives, subsidies on research, and low interest loan programmes for energy efficient construction and retrofitting in Germany
  - Discounts on climate change levy and capital allowances on equipment to improve energy efficiency in the UK
  - Exemption from local property taxes for up to five years on green buildings in France. The development of green property is strategic for the development of Islamic finance as the underlying investments are also Sharia-compliant.

	1. Stock exchanges	2. Support from International & local organisations	3. Educational institutions	4. Sukuk issuers	5. Sukuk investors	Ecosystem
France	NYSE Euronext Paris • Platform to issue sukuk • Does not have rating requirements	Paris Euro place • Teamed up with AAOIFI • Developed tax law guidebook to assist sukuk issuers under different laws	• Several educational Institutions offering specialised courses in Islamic finance	• No sovereign sukuk issue • Two corporate sukuk issues in 2012	• Private Placement Funds • Investors from the Middle East	In place More conducive for private placement
Germany	Frankfurt Stock Exchange • Sukuk and bond issues have the same listing requirements • One of the two most popular stock exchanges in Europe for sukuk listing.	• Turkey, being one of Germany's most important trading partners • Bank license granted to a Turkish bank to conduct limited Islamic banking operations	• Several educational institutions offering specialised courses in Islamic finance	• First sukuk issue in Europe (State of Saxony Anhalt) in 2004 • 13 foreign companies (Middle East & Malaysia) with overseas operations have listed corporate sukuk on the Frankfurt Stock Exchange • One corporate Sukuk issued via private placement in 2013	• International investors	In place More conducive for big corporations due to cost of issuance
United Kingdom	London Stock Exchange & Alternative Investment Market • No annual listing fees • One of the two most popular stock exchanges in Europe for sukuk listing.	• The Middle East, being one of the U K's most important trading partners • Strong government support through the establishment of the Islamic finance task force	• Renowned educational Institutions offering specialised courses in Islamic finance	• First sovereign sukuk issue in 2014 • 49 corporate sukuk listed on LSE to date by foreign companies (Middle East & Malaysia) with overseas operations	• International investors	In place Conducive for local medium-size enterprises. However, credit ratings of sukuk issued may deter popularity among investors
Turkey	Borsa Istanbul • No sukuk listing • All bonds listed are by Turkish companies denominated in Turkish lira	World Bank • Established the World Bank Global Islamic Finance Development Center in Turkey. • Provided $250 million loan to improve Islamic financing to SMEs	• Several educational institutions offering specialised courses in Islamic finance	• First sovereign Sukuk issue in 2014 • 1 potential corporate Sukuk issue received regulatory approval in 2014	• International investors	In place More publicity required to assure issuers on pricing

MONEY LAUNDERING – THE OFFENCE THAT DARE NOT SPEAK ITS NAME

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The views expressed are those of the author alone and should not be read as representing those of Police Scotland

INTRODUCTION

In the inaugural workshop of a series on the Proceeds of Crime Act (POCA) at Sussex University in October 2014, the National Co-ordinator of the Financial Investigation and Proceeds of Crime Portfolio for the Association of Chief Police Officers, Detective Superintendent Ian Davidson, commented that the text of the relevant proceeds of crime provisions didn't actually use the words, 'money' and 'laundering', although they are used as a heading.[1] He commented this was a good thing because the term 'money laundering' tended to evoke inappropriate images of cash in the British Virgin Islands or what happened on TV shows like *The Sopranos*.[2]

'Money laundering' has become a term of our age, a 'must have' inclusion in all descriptions of high powered economic crime and serious organised crime. But there is a considerable contrast between the extent to which people talk about money laundering and the incidence of high end criminals being prosecuted for it, except where the offences are essentially add-ons to other substantive charges. The money laundering offences set out in the UK legislation were designed to be effective stand-alone weapons against the practice in their own right, shed even of the obligation to define a predicate offence. But their use and application in criminal courts in that way has been muted, and the problem of high end money laundering is, if anything, even higher in the public consciousness as a problem that is simply not being dealt with than when the legislation was originally enacted.

In his recently published book *Criminal Capital: How the Finance Industry Facilitates Crime*,[3] Stephen Platt is also critical of the 'money laundering' label, calling it "misleading", and claiming "it has harmed efforts to prevent the activity it seeks to describe". Platt considers the conventional three tier explanation of 'placement, layering and integration' to be unhelpful too. Money laundering can occur without money being placed in a bank account and it isn't necessarily an active process. It often involves "relatively passive financial arrangements not identified by financial institutions as suspicious because they do not have the characteristics of a 'typical' money laundering relationship".

The implication of these comments is that money laundering as an offence has an image problem. That it is somehow not holding its own; that even its very name could even be seen as a distraction from the business of recovering criminal assets.

A CRIME WITH AN IDENTITY CRISIS IS A NOVEL CONCEPT. WHAT IS THE PROBLEM?

There exists something of an orthodoxy within some criminology departments, if not elsewhere, which might be characterised as a sincere and deep rooted agnosticism as to whether money laundering should be an offence at all. "It could be argued that there already existed a criminal framework for prosecuting the underlying predicate offence that gives rise to the funds to be laundered",[4] offers a leading academic commentator on money laundering, Professor Jackie Harvey of Northumbria University.

What is implied here is that money laundering is not a proper stand-alone offence; it depends for its existence on other crimes and it is these underlying crimes that should remain the proper focus of law enforcement.

The impression that money laundering still has to justify itself as a crime at the existential level appears to be given support by the startling fact, pointed out by Mr Davidson in the same workshop presentation, that in its six years of existence, the Serious Organised Crime Agency (SOCA) did not record a single offence of money laundering.

One basic problem the crime of money laundering has is an apparent lack of congruence between how it is defined in UK legislation and how it is habitually referred to in the academic literature, where its meaning is continually rooted in the concept of 'predicate offence'. The UK legislation is expressly framed in such a way that the principal money laundering offences are not directly linked to any predicate or specified offence. Indeed the expectation of one authoritative commentator in the wake of the enactment of the Proceeds of Crime Act 2002 (POCA) was that the US imported concept of 'predicate offence' could "be consigned to the jurisprudential dustbin".

As concepts go, predicate offence has shown itself to be stubbornly persistent, however. This may be because the need to characterise the offence as essentially a derived offence is perhaps necessary, or at least helpful, to the subtext that says it really isn't a proper offence at all. It therefore follows that the approach of UK legislation of stepping round the issue of predicate offence is not held up as a matter for approbation, but criticism, again by Professor Harvey, on the basis that "it is assumed (the author's underline) that laundering can be regarded as an activity, discrete from any predicate offence".[5]

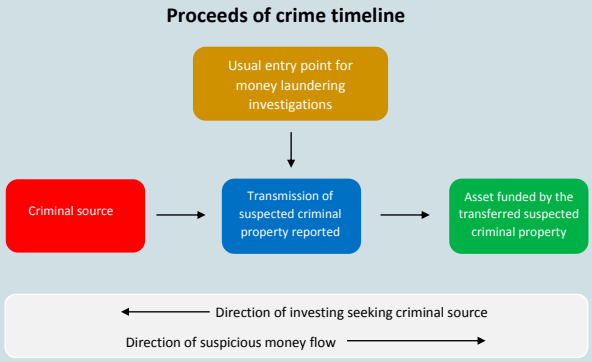
According to Professor Harvey, there are consequences that follow from these issues of definition: "The definitions of the 'headline' laundering offences are so wide that almost any financial transaction is capable of being laundering if some of the money or other property has its provenance in crime." And thereby the underlying purpose of the legislation, it is suggested, reveals itself: "By simply broadening the definition, the problem becomes bigger, attracting greater public attention … The result is that a rationale is supplied for yet further resources, such that the entire system becomes self-reinforcing."[6]

Harvey quotes with approval the view of Rahn[7] that this is an example of "the police creating increased demand for their activities by inventing new crimes". In case of any residual doubt, Harvey asserts: "the existence of enforcement agencies, and indeed the creation of new ones, results in a self-reinforcing, self-perpetuating rationale and legitimacy."[8]

1. *Proceeds of Crime Act 2002 (POCA) SS 327-9.*
2. *Podcast from POCA workshop, October 2014.*
3. *Stephen Platt, Criminal Capital: How the Finance Industry Facilitates Crime. London: Palgrave Macmillan, 2015.*
4. *Jackie Harvey, 'Asset Recovery: Substantive or Symbolic', Chapter 9 in Dirty Assets: Emerging Issues in the Regulation of Criminal and Terrorist Assets, ed. Dr Colin King and Professor Clive Walker. Surrey: Ashgate Publishing, 2014.*
5. *RE Bell, 'Abolishing the Concept of Predicate Offence', Journal of Money Laundering Control, 2003.*
6. *Harvey ibid.*
7. *Harvey ibid citation at reference 22; the phrase ultimately derived from R.Rahn, 'The case against Federalising Airport Security', Washington, DC: Cato Institute, 2001.*
8. *Ibid.*

As already mentioned, a key feature of the UK money laundering provisions (POCA ss. 327–329) is that they do not require specification of any predicate offence. Money laundering is therefore an offence in its own right. What is required is evidence which shows that the money or property that is the object of the offending action is criminal property and that the offender knows it is criminal property. What this definition means and how it is applied has been the subject of significant recent case law which will be discussed later. The design of the legislation, however, appears to recognise that the essential purpose of money laundering is to obscure criminal origins – and that an offence that was dependent on exposing the specifics of those origins would not achieve what it was enacted to do.

The entry point to most money laundering investigations involving organised crime is not the predicate offence but typically a Suspicious Activity Report relating to a transfer of funds deemed by the reporting party to be 'suspicious'. This information has the status of non-disclosable intelligence, and it is obviously the business of law enforcement to translate intelligence into evidence.



PROCEEDS OF CRIME

Proving the money is criminal by reference to the predicate offence would imply a retrospective trace of the funds to the criminal source. This is not a process that an organised crime group would typically find difficult to thwart. Indeed, a key characteristic of most laundering schemes of any sophistication is the prevalence of suitable disconnects.[9]

A break in the trail can be arranged without too much difficulty, for example, through parallel loan arrangements. The suspicious fund transfers reported on the SAR may therefore trace to a legitimate source but actually offset the settling of a related debt arising from funds directly derived from a criminal source. They represent criminal funds, in other words, as opposed to being funds which are directly derived from criminality. Does this therefore provide an effective means of protection against the POCA money laundering provisions? It surely should not. The POCA definition of 'criminal property' explicitly includes money or property that represents criminal property. Recent judgments, however, might be interpreted in ways which lead to a working understanding that in practice, reliance on a predicate offence is still a requirement.

There are cases where a trace to criminal source is possible; but in respect of the major organised crime prizes POCA was designed to help win, confinement to this approach carries the potential to engage in expensive, time consuming investigations which may prove ultimately unsuccessful. In cost conscious times, that can have an effect on the challenges undertaken that is heavily restrictive. The typical investigation entry point provides a natural focus on the characteristics of the transfer that caused the suspicions to arise in the first place. It was always understood that an inherent feature of the design of POCA was that it provided the means to construct a case whereby the requisite criminality, and the requisite criminal knowledge, could be obtained and proved by reference to circumstantial evidence relating to the manner and circumstances in which the money was treated.

The Crown Prosecution Service website sets out the position as follows:[10] "Prosecutors are **not** required to prove that the property in question is the benefit of a **particular** or **specific** act of criminal conduct, as such an interpretation would restrict the operation of the legislation. The prosecution needs to be in a position, as a minimum, to be able to produce sufficient circumstantial evidence or other evidence from which inferences can be drawn to the required criminal standard that the property in question has a criminal origin." It is perhaps unfortunate that this helpful statement of position is provided under the heading of 'Proving that proceeds are the benefit from criminal conduct in money laundering prosecutions (**proving the predicate offence**)', when really what it describes is how criminality can be proved without reference to a predicate offence. But this perhaps illustrates the very difficulties of perception as to what the crime of money laundering is that inhibits the ability to properly investigate it and prosecute it.

The ability to prove criminality through circumstantial evidence is also explicitly recognised in the relevant case law, specifically the case of R v Anwoir[11] (the key findings of which were endorsed for Scottish purposes in the appeal hearing in HMA v Ahmed):[12] "There are two ways in which the Crown can prove the property derives from crime, a) by showing that it derives from conduct of a specific kind or kinds and that conduct of that kind or kinds is unlawful, or b) by evidence of the circumstances in which the property is handled which are such as to give rise the irresistible inference that it can only be derived from crime."

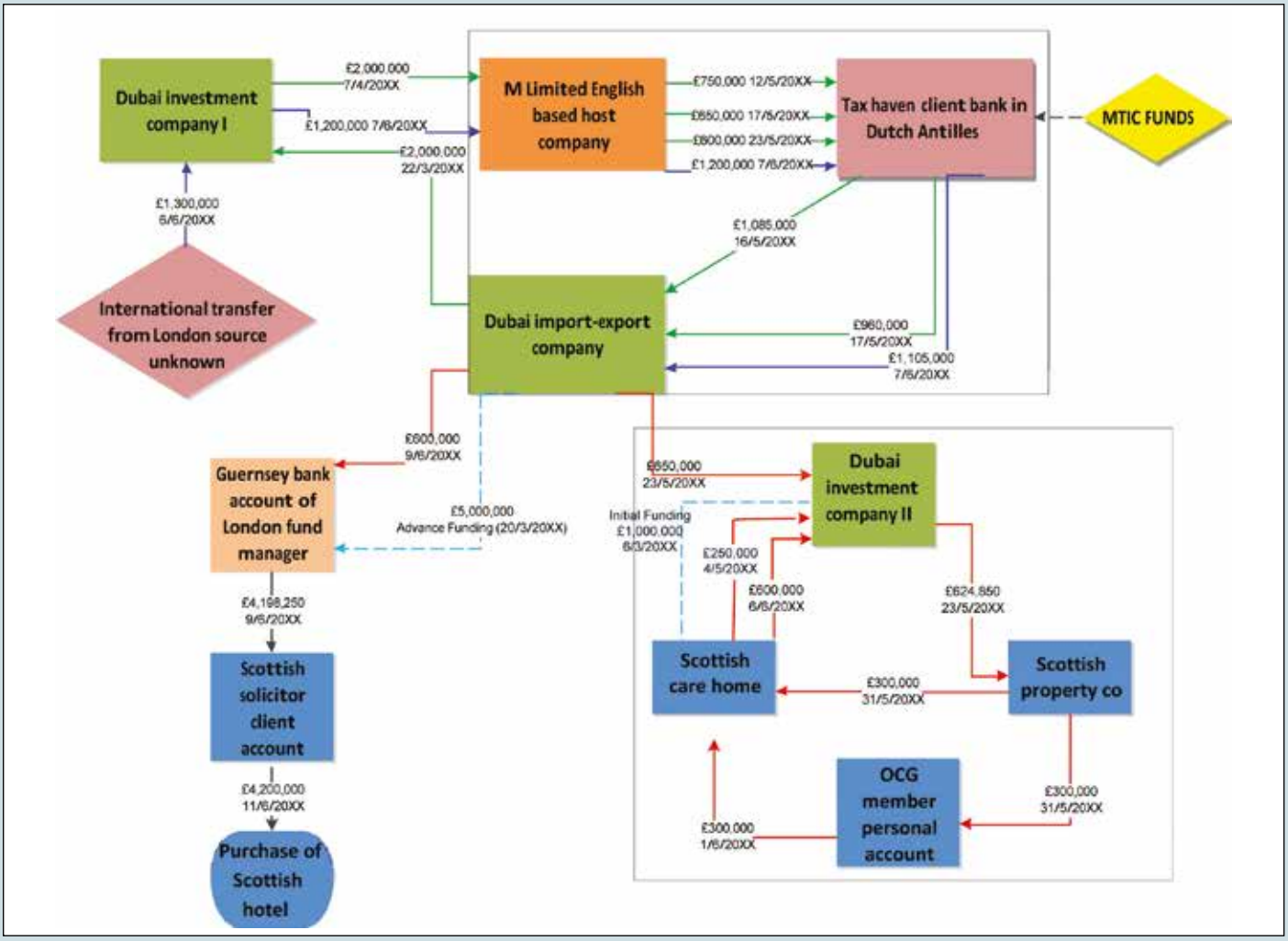
Even though the 'irresistible inference' test is now established, however, there is still ground to cover in terms of achieving a necessary consensus as to how the required standard of criminality can be proved. This is not an issue solely of how the legislation is interpreted, but also an issue of how the crime is typically committed by the organised crime groups posing the threats which, as Dr Peter Sproat, a lecturer in policing, points out, led to the enactment of the legislation in the first place.

The following is a real life example of a money laundering scheme where the identities have been fictionalised. The essence of the scheme was to use profits earned from drug trafficking by a Scottish Organised Crime Group (OCG) to secure the purchase of a local hotel. The method used to launder the money involved a labyrinth of corporates set up by another Scottish OCG to commit VAT fraud (of the type referred to as Missing Trader Intra Community Fraud – MTIC).

Essentially this was an instance of two OCGs teaming together on the basis of their distinctive capabilities. One generated income in Scotland that needed to be laundered; the other could launder it through a mechanism set up to execute MTIC fraud. The second OCG wanted to invest its criminal profits in Scottish property assets and the first OCG could help it do that by executing land purchases and securing through corrupt planning permissions, which would subsequently increase the value of those land assets.

Proving the overall scheme to a criminal standard of proof was obstructed by delays in obtaining international letters of request (ILORs) from Dubai and the hugely complex process of tracing the MTIC funds through to

9. See Platt ibid.
10. CPS.gov.uk Proceeds of Crime Act 2002 Part 7 – Money Laundering Offences, http://www.cps.gov.uk/legal/p_to_r/proceeds_of_crime_money_laundering/
11. R v Anwoir [2008] EWCA Crim 1354; [2008] 2 Cr. App.R.36.
12. HMA v Ahmed [2009] HCJAC 60.



criminal source (which was nevertheless achieved). There was also no substantive evidence which pointed to the Scottish drugs money being entered into the scheme (ie, the so-called 'placement' evidence).

In these circumstances, was it realistic, necessary or desirable to have to prove by reference to the whole scheme that the money was criminal, or should it not have been possible to prove the necessary criminality via irresistible inference from the available evidence of deceit? If there were parts of the scheme which could be evidenced to show deceit with the purpose of constructing false legends for the passage of monies, should that not have been sufficient to meet the necessary tests for the POCA money laundering charges?

The activity contained within the two boxes in the diagram above involved the creation of false invoices to enable related transfers of money: first from London to Dubai via Holland; secondly, from Dubai to Scotland, back to Dubai, via Holland to the Scottish solicitor who handled the settlement for purchase. The evidence of the deceit through the invoices was complete and beyond challenge.

In the context of an overall scheme where financial benefit can ultimately be traced to a number of individuals with criminal connections, should the existence of such compelling evidence of deceit within the two boxes provide sufficient evidence of criminality on their own?

In this case, it was the opinion of senior counsel that there was enough evidence to secure money laundering charges against the principals of the Scottish OCG – but only in the context of the whole scheme and 'not overwhelmingly so'. It was suggested the prospects of conviction might not outweigh the considerable financial risk of the case proceeding; advice which was taken by the lead prosecutor, being HMRC in London (the case ultimately became a joint enterprise between HMRC and the former Scottish Crime and Drug Enforcement Agency).

Experiences such as this obviously educate the prosecuting authorities, particularly in terms of key resource allocation decisions. But they also educate the launderers themselves as to the characteristics of money laundering schemes that are likely to prove resilient to prosecution.

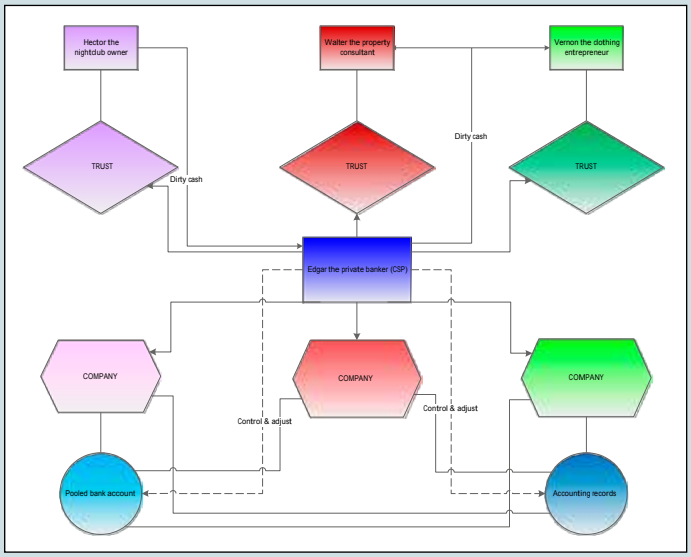
The reality of modern money laundering is that arrangements are made precisely so there is no continuity of linkage between predicate crime and the visible channels used to launder the proceeds. Breaks will be engineered and other funds substituted to make sure that a classic 'follow the money' back to the crime investigation will meet a cul-de-sac in terms of an apparently genuine legitimate source, or an obscure labyrinth of interconnected transactions showing an ultimate source that is untraceable.

This essential characteristic of money laundering schemes is laid out in Platt's recently published *Criminal Capital: How the Finance Industry Facilitates Crime*. Platt argues the 'placement-layering-integration' model of money laundering does not reflect its reality. His preference is for an 'enable, distance and disguise' model, which encompasses a wider range of facilitation and laundering conduct. Platt's model is designed to assist banks become more effective in their AML procedures and suspicious activity screening. But it

surely also points to a need to overhaul the basics of how the crime of money laundering is conceived in the criminal justice process.

Platt's book includes a number of scenarios which purport to show how criminal finance operates in reality. They can be readily vouched as reflecting actual law enforcement experience. The real life example provided above mirrors the principle features of the Platt scenarios, including the use of pooled bank accounts, corporate service providers, and the exchanging and settling of debts using dirty cash such that it never needed to enter the banking system.

The simplified fictional scenario described in the diagram below is adapted from the shape of one of Platt's scenarios (pp.79–83) to reflect actual experience of some of the mechanisms encountered from recent money laundering investigations.



The central figure in this arrangement is the central private banker, Edgar. He is a corporate services specialist who oversees a pooled bank account and a set of books. He also arranges for dirty cash pick-ups from Hector the night club owner, whose premises act as a drop venue for criminal funds. These funds do not touch any set of books except those kept by Edgar. Neither do they touch any bank account, for the cash that is collected by Edgar is used to settle debts owed to other subscribers to Edgar's services. Note there is no line in the diagram that directly links the top half to the second half. The link is through Edgar. Needless to say the bank account is offshore and the location of the books is probably firth of the jurisdiction too. There aren't going to be any SARS generated from any of this activity and the placement-layering-integration axis is irrelevant.

The essence of this scheme, and indeed any money laundering scheme above the most basic, is that disconnects are built into the arrangements as a fundamental feature so that there is no provable link between the money identified as suspicious and any predicate crime.

In his next article in the *Review of Financial Markets*, Kenneth Murray will consider whether POCA is up to the challenge of dealing with present-day crime; the $1tn role of trade-based money laundering; and 'Project Jackal', Scottish Police's approach to translating a conceptual framework based on business strategy analysis to a practical programme capable of delivering tangible results in the public-private fight against money laundering and other economic crime.

THE REGULATORY RESPONSE TO FINANCIAL INNOVATION

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The credit crisis triggered profound changes in financial markets and institutions. Since it started, regulators have sought to address the systemic failure that led to it. They have named, shamed and fined the guilty parties (see table from the CCP Research Foundation on pg. 44). That said, regulators have yet to fundamentally question their own failure to keep pace with financial innovation. They should not forget that it was the creation and promotion of new financial instruments, technologies and business models that sowed the seeds of the crisis. Unless we become more proactive in regulating them, we are set to repeat the mistakes of the past in novel new ways.

The response to the crisis prompted wide-ranging regulatory change in both Europe and the United States. Some of the response was for the better. The point, however, is that it was a kneejerk reaction and not supported by critical analysis. There was little research into how the changes would impact capital markets.

There has also been little debate on what differentiates good regulation from bad (or overly-onerous). Academia has a clear role to play in answering this question and in bridging the gap. It can do this through empirical evaluation and robust testing. After all, it was asset pricing research that led to the very innovation that now requires regulation. The academic body of knowledge, as encapsulated in the CISI exam syllabus, shaped capital markets into what they are today.

The credit crisis started because of issues in the sub-prime lending and securitisation markets. That said, the two common denominators that made the crisis systemic were financial engineering and deregulation. The lesson that should be learnt is that regulation has to keep pace with financial innovation in order to accommodate free functioning capital markets.

If one wants to see how rapidly innovation is occurring, one only needs to look to what has become termed fintech. Pre-eminent amongst financial innovation, fintech promises the creation of a global cryptocurrency. When (rather than if) this happens, payments and financial transactions will move to an instantaneous settlement basis. Regulators will have to be ready for this. It's not possible to shut the gate after the horse has bolted, or in this case the trade settled.

It is not just digital money that is changing. Any product that can be traded can become financialised. Consider carbon credits and energy trading for example. Indeed, data of any kind is an 'asset' that has 'value'. New products will be based on these, such as the oft-cited 'cloud'. These will have to accommodate mainstream markets. They will have to be monitored and regulated.

Meanwhile, the internet is changing the world. It is not just secondary markets that are evolving; primary markets are also being impacted. Crowdfunding, for example, is an area in which developments are currently outpacing the regulators. There is a need to keep up with both the digitalisation and financialisation of industries. Look at what is happening to investment in art markets or developments in derivatives on the weather. Further change is on the way.

The pace at which regulators adapt to innovation is important because theory suggests the regulatory process as one of competition among interest groups. This implies that financial institutions, which are likely to receive concentrated gains from regulation, are typically more

1. *Strathclyde Business School's mission is to foster policy relevant research to support the practical application of innovation in finance. It aims to encourage regulatory principles, rules and guidance that are simple, understandable and clear. It supports regulatory requirements, oversight and intervention that reflect the nature, scale, sophistication and complexity of financial market participants.*

effective at lobbying for their interests than investors or savers. This can distort markets. There is therefore a need to provide an independent and impartial advocate to promote the best interests of capital markets in the face of new financial innovation.

Clearly, the pace of change is fast. The crisis revealed many systemic problems arising from so-called shadow banking activities. Such 'credit intermediation' came from innovation. In effect, financial markets created entities and activities outside the regular banking system. This is another area of innovation that has to be addressed.

In the same vein, new and novel strategies are being devised. These come from new areas, such as behavioural finance and neuro economics. Regulators do not fully understand them but are responsible for their oversight. Systems, product design, investment process and measurement will all change. Even our very concept of risks (their proxies, variance and standard deviation) is being revisited.

Regulation should not just be about making law and enforcing it. It must also support trust and confidence. This is particularly true in the financial services sector and for its participants. Adoption of new rules and oversight should be done in conjunction with the development of a strong culture of ethics, a focus on clients and a respect for fiduciary interest. It should promote skills rather than just make boxes for people to tick.

Some may question whether academic research can fill the gap. Many practitioners complain about the assumptions academics make and on which financial models are built.

Let us not forget that academic theories have changed the world of finance. A large part of the world's professionally managed money is indexed. The Arbitrage Pricing Theory gave birth to factor-based risk evaluation. The Black-Scholes options pricing model underpins the derivatives markets. Capital decisions, firm structure and the amount of leverage a firm takes on should optimally be based on theory. Thanks to academic models, it is generally agreed that there is a mathematical relationship between risk and return.

Practitioners argue that individuals are not rational, markets are not frictionless, information is not ubiquitous and data not normally distributed. They are to some extent right. Theoretical research does not take account of asymmetric information, trading costs, liquidity and tax. That said, it is robust and its conclusions are statistically based. Even so, research often pits academia against the world of active asset managers. This is because theoretical academics tend to be too dismissive of the persistence of risk-adjusted investment outperformance. It is a grey zone that needs to be more clearly delineated. Not everyone can be a passive participant in financial markets.

Despite all this, market efficiency is an important element in finance. Regulators need to worry about it because it is the backbone of finance. It provides the basis for price discovery and the continuous restructuring of the economy. Well-run markets support economic growth and facilitate capitalism. On a similar note, sound implementation of financial theory improves the efficiency of capital decisions, thereby favoring a better allocation of scarce economic resources.

Current issues, such as governance and internal corporate capital allocation, particularly in respect of pay and incentives, are even more immediate. The role of institutional investors is under scrutiny and regulators have taken note. Once again academia can step up to the plate. Research designed to improve institutional investor involvement and shareholder participation is needed. The billions of dollars of fines paid by the banks are testimony to the importance of getting governance right.

Academics can help policy makers, regulators, and finance industry professionals address the issues pertinent to financial regulation and innovation. They need to be the strategic link between policy makers, regulators and other financial industry participants. In this way, research insights into financial regulations, banking policies, risk management, investment benchmarks and corporate governance can be adopted by capital markets. This can be done with investigation and appropriate comment; especially on policy matters that relate to global financial markets in general and in the United Kingdom and the European Union in particular. After all, peer reviewed theoretical research drives both growth and innovation in the financial sector. It can assist government, regulators and industry. The aim should be use it to anticipate appropriate industry structures, governance and policy frameworks, regulatory systems, and responses.

In conclusion, with financial innovation happening at such a fast pace, there needs to be timely, economic, industry and social arguments for any change in regulatory oversight. There is a need for new rules, based on innovation that involves either leverage, derivatives or risk models. These must be developed with a better understanding of their impact. More effective capital markets and decision making is Pareto optimal for society.

WHAT CONCERNS US NOW?

These pages display concerns about criminality, regulation and major fines (opposite). What worries global financial practitioners? One of the sharpest regular surveys for the past 20 years has been *Banking Banana Skins* from the Centre for the Study of Financial Innovation (CSFI), a London and New York-based think tank with which the CISI works closely. The latest survey, conducted in the final quarter of 2015, describes the risks currently facing the global banking industry, as seen by a wide range of bankers, banking regulators and close observers of the banking scene around the world. The survey received 672 responses from individuals in 52 countries, from the CSFI's own contacts and those of PwC, the sponsors. The changing nature of risk was summed up by the sharp rise in concern about criminality, up from number 9 in the last survey to number 2 this time round, chiefly because of the alarming spread of cyber crime in an increasingly borderless market, particularly data theft. This, the survey points out, is closely related with technology risk (number 4) where underinvestment and obsolescence, and banks' growing exposure to competition from 'fintech' companies, now present major challenges. One of the strongest risks is concern about the quality of banks' risk management, which rose from number 11 in 2014 to number 6 in the latest survey. Although much work has been done by banks and their regulators to strengthen risk controls, there is a sense that banks have still not adequately addressed not just the scale of risk but also its changing nature.

"I am somewhat surprised," says Dr Andrew Hilton, the Centre's Director, "that concerns over regulation fell this year, albeit only to number 3 [from the top spot in 2014] when signs of regulatory 'herding' – a lack of diversity – abound and when banks face massive financial retribution for their post-2007/8 sins." See next article.

But that's what the banana skins survey is all about, he says:

> You don't have to agree – or to believe in the salience of the risk landscape exactly as painted by respondents. Rather, *Banana Skins* is intended to make the reader stop and think – and perhaps to adjust his or her behaviour accordingly. By itself, it won't protect against a banking crisis, but it can – at least – provoke a discussion that might protect an individual institution from leaping over the cliff with the rest of the lemmings.

For details of *Banking Banana Skins*, and how to get a copy, see *www.csfi.org*

George Littlejohn MCSI

THE RISING TOLL OF CONDUCT COSTS ON GLOBAL BANKS

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It is not obtuse to suggest that following closely in the wake of the immediate 'financial' crisis was a crisis of 'misconduct' – some might argue that one, in fact, begot the other. And, despite being eight years on from 'Lehman' and the onset of the crises, organisations are still battling to regain the trust that was lost; trust that now largely centres on the ethical compass of individuals rather than the solvency of the organisation.

It is, of course, almost impossible to guarantee that people will behave in a certain way: an immutable consequence of one's free will. A bank cannot reduce to zero the risk of a trader going rogue. But it can create an environment in which, you might say, 'conduct/people risk' is identified, measured, and actioned in the interests of stakeholders, whether that be the organisation's clients, counterparties, employees, or the public at large. The essential question nevertheless remains: how do stakeholders test these more nebulous risk concepts when the traditional metrics for financial appraisal only tell half the story? A bank, whose business practices might be applauded on the basis of its financial performance in one year, might be harbouring an unidentified/unmitigated level of conduct risk that, if known, would question the bank's sustainability and trustworthiness. You have to look 'behind the balance sheet' at reliable metrics for evaluating (and predicting) an organisation's culture and conduct record.

This is what the Conduct Costs Project (the Project),[1] sponsored by the CCP Research Foundation CIC,[2] was set up to do. The Foundation, established in 2014, evolved from a project at the London School of Economics, where, in 2012, its Director, Roger McCormick, began exploring the impact that conduct and culture can have on long-term bank sustainability. Set in the context of banks' 'restore public trust' agenda and the apparently inexorable rise in regulatory penalties being imposed on banks, the Project's principal purpose was to track bank 'conduct costs' and apply the results to the development of an objective, reliable indicator of trust (and you might argue, of non-financial risk).

The Project pioneered the utility, disclosure and reporting of conduct costs, as a highly objective indicator of the negative effect of 'inappropriate culture'. The hypothesis is that the roll out of a unified system of conduct cost reporting across all financial services participants, worldwide, will over time demonstrate whether banks are in fact becoming more or less effective in changing culture and ushering in a new era of ethically appropriate behaviour and financial sustainability. If the current very high level of conduct costs is not reduced, and soon, it would take a brave man to argue that banks really have 'turned the corner'. Even though certain banks may be able to easily afford multi-billion dollar fines, it would be a risky strategy to say to the public, in effect, 'we know we're bad but we can afford to be'. Some banks, however, may be more successful than others. So the need to have accurate figures on a per bank basis is crucial.

There is no generally accepted definition of conduct costs. The box below sets out the Project's working definition. It is such that it ought to capture behaviour that impugns the integrity and good standing of the bank, on an objective basis. The scope of the definition is not limited to materiality (of whatever measure, be it balance sheet, bank reputation and sustainability or stakeholder sentiment), as all instances of misconduct should fall to account. Indeed, from a risk management standpoint, the bank ought to record, assess and 'learn' from all manner of misbehaviour, whether or not its consequence is financially material. Misconduct taken in isolation might be inconsequential. It may, equally, however, indicate a trend – a pervasively operating misaligned incentive – that, if left unresolved or unmanaged, could lead to significant damage over time (to customers, shareholders, and the firm's reputation).

What are conduct costs?

Conduct costs means all costs borne by a bank in connection with any of the following:

1. regulatory proceedings, specifically (but not exhaustively):
   a. fines or comparable financial penalties imposed on the bank by any regulator
   b. any sum paid to a regulator or at the direction of a regulator in settlement of proceedings of any kind
   c. any sum paid to, or set aside to be paid to, any third party or parties to the extent required by any regulator
   d. any sum paid, or set aside, for the purchase (or exchange) of securities or other assets to the extent required by a regulator and (if such information is available) to the extent such sum exceeds the open market value of such securities or other assets as at the date of purchase
2. any costs, losses or expenses which are directly related to an event or series of events or conduct or behaviour of the bank or a group of individuals employed by the bank for which any fine or comparable penalty has been imposed or any censure issued by a regulator
3. any sum that has become payable as a result of, or in connection with, any breach of any code of conduct or similar document entered into, or committed to, at the request of, or required to be entered into or committed to by, any regulator or any public, trade or professional body
4. any loss of income or other financial loss attributable to a requirement imposed by a regulator to place money on deposit with a central bank or other institution at below the market rate of interest, being a requirement imposed in connection with a breach of law or regulatory requirement
5. any sum paid in connection with any litigation (whether ordered to be paid by a court or tribunal or in settlement of proceedings) where the litigation involved allegations of material wrongdoing or misconduct by senior officers or employees of an institution which were not refuted
6. any other sum, cost or expense, not falling within any of (1) to (5) above that is paid pursuant to an order or requirement of a regulator and which is a result of any breach of any regulatory requirement or law.

Given the significance of conduct costs to culture, to regulatory and public perception of conduct generally, and to conduct risk management, we might reasonably expect banks to be keen to report on this fundamental metric.

The Project has published its research into the conduct costs of sixteen of the largest banks incurred for the period 1 January 2008 onwards. Below is a summary of the Project's findings in the form of a table of conduct costs for the five-year period ending 31 December 2014.

1. http://conductcosts.ccpresearchfoundation.com
2. http://ccpresearchfoundation.com

As can be seen, the conduct costs incurred by those banks over that period (including provisions as at the end of 2014) came to more than £200 billion; not an insignificant sum. And, while the Foundation's research into the 2015 figures is ongoing (with the addition of further banks, taking the total to 21 of the world's largest financial institutions), it is regrettably anticipated that the level of conduct costs as at the end of 2015 will be of equal (if not greater) magnitude. The Project expects to publish a revised Results Table in May 2016, accompanied with updated summary analysis. Access to the detailed data underlying the results (and the opportunity to explore more in-depth analysis and correlative research) is, however, limited to member's of the Project's Association[3]. Those interested in becoming members are welcome to contact the authors.

CISI members may also be interested to hear that, among its other projects, the Foundation is working with Cambridge Judge Business School[4] to develop (through active and collaborative engagement with/by the banks) a set of best practice, tested and ethically-centric standards that assist firms in navigating, specifically, 'grey areas' with high conduct risk (such as where traditional regulation fails to provide a definitive answer). Further details of the 'standards project' will be available on CJBS and the Foundation's websites in due course.

A presentation on the work of the CCP Research Foundation to CISI members by Roger McCormick and Chris Stears in February 2016 is now available on CISI TV

CONDUCT COST DISCLOSURE

There is currently no enforceable requirement for banks to make specific, full and meaningful disclosure of conduct costs. As such, published annual reports and accounts, constructed under GAAP and IFRS rules, contain no readily comprehensible report on conduct costs and their implications. Meaningful disclosure is voluntary and only then in so far as the organisation is required to report 'material events'. There are clear differences in the terminology and granularity used by banks, with conduct costs often subsumed within an aggregated accounting entry marked, for instance 'litigation cost' or 'other expenses'. The aggregation of conduct costs conflates disparate operational costs: not all litigation costs are rightly considered conduct costs in the sense that they may arise otherwise than as a result of 'misbehaviour'. This practice does not assist the bank in identifying what misbehaviour looks like (and its current and future cost (financial and non-financial). This issue is recognised at the European regulatory level, with the European Banking Authority's (EBA) Risk Assessment Questionnaire (RAQ) providing some conspicuous results. The EBA notably reported that:

> Claims have nevertheless often been made that there are challenges to quantify aggregated redress costs. While expenses provided for compensation and redress payments have increased, rising and increasingly materialising conduct risks raises the questions as to whether risks are sufficiently provisioned for, and whether provisioning is adequately disclosed. Claims have been made that there is a lack of disclosure on details of redress costs, and responses to the RAQ provide indications that some of these claims could be justified. Only 18% of the RAQ respondents indicated that they set aside and disclose contingent liabilities for potential compensation, redress, litigation and similar payments, and disclose them. (Authors' emphasis)

Conduct costs for the five years ending 2014 in £bn

Banks	Total costs 2010–2014 (£bn)	Provisions as at 31 Dec 2014 (£bn)	Grand total 2010–2014 (£bn)	*Grand total 2009–2013 (£bn)*
Bank of America Corporation	55.80	8.25	64.05	*66.40*
JP Morgan Chase & Co	28.65	4.26	32.91	*35.78*
Lloyds Banking Group	12.24	3.38	15.62	*12.72*
Citigroup	12.17	2.58	14.75	*7.57*
Barclays	8.00	4.59	12.59	*7.89*
RBS	6.79	4.11	10.90	*8.47*
Deutsche Bank	6.01	3.37	9.38	*5.62*
HSBC	6.39	2.29	8.68	*7.21*
BNP Paribas	6.04	1.72	7.76	*3.54*
Santander	3.87	3.07	6.94	*3.57*
Goldman Sachs	4.05	2.08	6.13	*3.65*
Credit Suisse	4.01	1.84	5.85	*3.58*
UBS	3.42	1.99	5.41	*4.18*
National Australia Bank Group	1.83	1.00	2.83	*2.34*
Standard Chartered Bank	0.96	0.05	1.01	*0.76*
Société Générale	0.08	0.86	0.94	*0.70*
Grand Total [GBP Bn]	**160.31**	**45.44**	**205.75**	*173.98*

Source: CCP Research Foundation

3. http://conductcosts.ccpresearchfoundation.com/about
4. http://foreigners.textovirtual.com/ccp-research-foundation/271/195787/ccp-research-foundation-and-cct-at-cambridge-business-school-pressrelease.pdf

Investing in life

ANITA BROWN, CHARTERED FCSI, EXPLAINS WHY SHE VOLUNTEERS HER TIME AS A FIRST AIDER

LORA BENSON

Anita Brown, Chartered FCSI, has been a volunteer first aider for over 11 years with the British Red Cross and, more recently, St Andrew's First Aid.

The challenging volunteering duties help to take her mindset "to a totally different place" from her extremely busy day job as Investment Manager at Quilter Cheviot's Glasgow office, where she has worked for the past 14 years. Thankfully, says Anita, she has rarely been called upon to use her first aid skills in the office.

NEW EXPERIENCES

However, her volunteering has allowed her to work at a large variety of events around Glasgow, where her duties are based. Anita says: "Over the years I have covered everything from small school fetes to large stadium concerts, the Special Olympics, Commonwealth Games, Pipe Band Championships, music festivals and football games. You never know what might happen while on duty – it could be the busiest football match and nothing happens, or it could be the smallest country fair where you are rushed off your feet.

"I enjoy helping people and I get a great sense of satisfaction at the end of a duty that I have done something useful – even if there hasn't been any first aid required! There is also a great camaraderie amongst the first aiders and it is a constant learning process."

ANITA AT WORK IN HER DAY JOB AND AS A VOLUNTEER

To qualify as a volunteer first aider, Anita initially had to obtain a Standard First Aid certificate, which is renewed every three years with annual assessments. Additional training is ongoing and includes: the use of an automated external defibrillator; moving and handling training, which shows how to safely move casualties and equipment; and scenario-based learning. Continuing professional development is also carried out at group training nights, which provide volunteers with additional information on a wide range of subjects, such as allergies.

"Each of us has it in us to make a difference – and potentially save a life"

Anita also holds the First Aid at Work qualification, which meets the standards required to comply with Health and Safety (First Aid) Regulations, and specifically covers the treatment of adults in the workplace. Indeed, she originally became a volunteer after attending one of the refresher courses for this qualification, which too needs to be renewed every three years. The course provider, the British Red Cross, mentioned that it was always looking for volunteers. Anita says: "I thought this was an ideal way to keep my skills up to date, while also doing something interesting and worthwhile in my spare time."

In 2007, Anita was awarded the British Red Cross Badge of Honour for Devoted Service. In 2014, she joined St Andrew's First Aid. Its mission statement is to "provide Scotland with the highest standards in first aid skills, services and volunteering opportunities".

Anita loves the flexibility that volunteering as a first aider allows: "How much you want to do depends on your own time constraints – I attend group training meetings once a week and usually try to do at least a couple of duties each month."

In Anita's experience, the reasons that people need first aid treatment can vary greatly: "From trips, falls, cuts, burns, substance abuse to pre-existing medical conditions. When you respond to a call, or come across a casualty, you never quite know what you are going to come up against – that is why we train on a regular basis.

"We have to have good people skills, be able to think on our feet, possess the ability to take control of a situation if required and – of course – be able to reassure the casualty. First aiders always work in pairs when on duty at an event, and are part of a larger team, so we are never left to deal with a situation on our own. A sense of humour and a willingness to help are also prerequisites."

SOMETHING FOR EVERYONE

One aspect of first aid services that Anita would like to see developed is basic first aid training. She would make it a part of the school curriculum and compulsory for new parents. People can need first aid at any time – for anything from a simple cut finger to a heart attack, whether it is in the home, office or in the street. "First aid isn't difficult; most of it is just common sense." Anita would encourage everyone to learn even a little basic first aid.

"Each of us has it in us to make a difference – and potentially save a life."

If you are interested in volunteering as a first aider visit the following sites for details:

- St Andrew's First Aid
  www.firstaid.org.uk

  British Red Cross
  www.redcross.org.uk

  St John Ambulance
  www.sja.org.uk

Contact *lora.benson@cisi.org* if you have a hobby you think will interest other CISI members. You will receive a £25 shopping voucher as a 'thank you' if we publish your story.

iStock

Wine and dine dilemma

CEO HARRIET MUST DECIDE WHAT THE CORRECT PROTOCOL IS WHEN A SUPPLIER REPEATEDLY TRIES TO GIVE A PERSONAL GIFT AGAINST COMPANY POLICY

Harriet is the CEO of a small wealth management firm with about 100 staff members. The company has a gifts policy in place which states that all gifts received must be declared to the HR manager. Items of low value or items that have been personalised or engraved (such as pens or calendars) may be kept after being declared. Additionally, gifts may be kept if they have been given as a result of a personal connection or relationship – but this is subject to Harriet's discretion. Otherwise, all gifts are held by HR and staff members are given the chance to enter a raffle and win one of the gifts on the day before the office closes for the Christmas break.

One of the firm's suppliers is a small, privately owned printing company, Rainbow, to whom the firm has sent all of its printing for

a number of years, and where Harriet has a friendly relationship with its Managing Director, Herman.

In early December, a package arrives from Rainbow containing six bottles of wine, with a generic note saying: "Thank you for being such a great customer this year. We hope that your staff members enjoy this contribution to your Christmas gift raffle." This is not unusual – Rainbow has sent the same gift for the past two years in a row – and the package is given to HR to be declared and added to the collection of other gifts received throughout the year.

PERSISTENT PRESENTS

However, a week later another package arrives from Rainbow, addressed personally to Harriet. This is a bottle of wine, which Harriet knows is more expensive than the wine already received. It is accompanied by a slightly cryptic note from Herman to Harriet: "I know your policy is to share gifts between your employees at Christmas, but I did not want you to feel left out."

Harriet sends this gift to HR to be added to the Christmas raffle and sends a polite note back to Herman thanking him for the wine, saying she is glad that he has enjoyed working with her, but that she is sure that Herman will understand that she cannot ignore the firm's rules just because she is the boss.

A week or so after returning to work following the Christmas break, Harriet receives an email from Herman inviting her to lunch with him in a few days' time. Harriet is happy to accept as it does not appear that Herman has taken offence over the note she sent to him regarding the bottle of wine. Herman says that he will meet Harriet at her office and they can go on to the restaurant together.

The package is given to HR to be declared and added to the collection of other gifts received

As arranged, Herman calls for Harriet at her office, and tells Harriet that he has booked a table at a well-known restaurant, just a short walk away. Harriet has not been there before as it is considerably more expensive than she would normally choose for a business lunch. Nevertheless, she enjoys a convivial lunch with Herman, whom she is able to reassure that the firm has no current plans to change its suppliers and they part on good terms.

A few days later, Harriet arrives home late after attending an evening function and is greeted by her partner who says that they have received a package, which she opens to discover two bottles of rather good claret in a very nice presentation box. There was a note from Herman, which said simply: "Enjoy!"

Slightly irked by the prospect of having to lug the heavy box in to work at a time when she is very busy, Harriet thinks no more about it and goes to bed.

With Harriet's heavy schedule, the matter of the wine slips from her mind until a few weeks later when preparing for a dinner party. Her partner says that he has opened the wine that Herman sent as it looks rather good.

On hearing this, Harriet sighs, remembering that she had meant to take the wine in to work and give it to HR to hold until Christmas. Clearly this is no longer an option.

WHAT SHOULD HARRIET DO?

A. It's just a couple of bottles of wine given to her personally, so she can enjoy them with a clear conscience. Cheers!

B. She must find out the price of the gift package and contribute an equivalent value of wine to the staff 'Christmas fund'.

C. Recognise that the action that Herman has taken is a deliberate attempt to circumvent the firm's policy on gifts, which he is aware of. This calls into question his overall standard of integrity. Might this extend to his business dealings? She must review the firm's dealings with Herman.

D. She must write to Herman, from the office, in polite but strong terms, telling him that his generosity was misplaced in sending the gift to her home, as he knows that she cannot accept it. She will warn him that he is in danger of upsetting their previously good professional relationship.

WHAT WOULD YOU ADVISE?

Visit *cisi.org/wineanddine* and let us know your favoured opinion. The results of the survey and the opinion of the CISI will be published in the June print edition of the *S&IR*.

IN A JAM: THE VERDICT

December's dilemma concerned a situation in which many of us may find ourselves on occasion: what should we do when designated chains of command are broken? When is it appropriate to take a decision ourselves and when should we refer upwards?

In this instance, a transaction sanctioning line was broken by holiday absence and travel delays, compounded by a lack of co-operation from a designated person, who was leaving the firm, which raises other issues.

The 68 readers who voted had four options to choose from. Javid, the junior person involved in the dilemma, should:

A Report the matter when Delores (line manager) returns from holiday on Monday (18% = 12 votes).

B Do nothing. The payment has been made with the necessary authorisations, albeit one of them was obtained in an irregular manner (3% = 2 votes).

C Escalate the matter although conscious that it may result in criticism of your colleagues (71% = 48 votes).

D Let Claire (the supervisor) handle it; it is her problem. Javid is only doing what he is told. (9% = 6 votes).

Although the majority vote in favour of escalation is quite clear, it does mean that 20 people voted not to escalate the matter and essentially keep the problem within the team. Our view is that this is definitely a situation where honesty, openness, transparency and fairness are paramount and there is no merit in trying to keep the problem within the team.

Who wants to be a non-executive director of a UK financial institution?

A LOOK AT THE LIABILITIES AND RISKS OF EXECUTIVE AND NON-EXECUTIVE DIRECTORS UNDER THE SENIOR MANAGERS REGIME

FRANCIS KEAN, EXECUTIVE DIRECTOR, WILLIS TOWERS WATSON

Getty

This is not the title of a new game show. Instead it is a question of vital interest to the regulators and stakeholders of financial institutions. That's because, under the unitary board system, non-executives are expected to play an important role in protecting the interests of depositors, clients and shareholders. It is not hard to list the desired qualities of such individuals, such as integrity and experience, combined with a range of relevant qualifications and skills. However, unlike the famous game show, the answer here is not so obvious. Yes, the role is likely to be interesting, challenging, stimulating and rewarding, but there are a number of sobering factors to take into account.

THE RISKS

Here's a non-exhaustive list:

- Under English law, non-executive directors are held to the same standard of skill and care as their executive counterparts
- Under English law, a director cannot delegate his or her ultimate supervisory function

- Banks (and investment banks in particular) tend to be large complex animals, not always easily understood in terms of structures, products and services
- Regulatory and operational risks for all banks are increasing, as are the cyber-related vulnerabilities they face
- From March 2016, all non-executive directors of banks will be subject to the revamped Conduct Rules of the Financial Conduct Authority
- From March 2016, the Chairman, the respective Chairs of the Risk, Remuneration, Nomination and Audit Committees and the Senior Independent Director will additionally be subject to personal accountability under the Senior Managers Regime
- The FCA now has up to six years in which to bring enforcement actions against individuals, by which time they may no longer be in post.

THE ISSUES

When weighing up any offer of appointment, individuals will want to conduct their own due diligence exercises into the institutions concerned, and to negotiate carefully the terms of their appointment, including, of course, the level of their remuneration (in particular, they may wish to focus on their respective rights and obligations with respect to information sharing and document retention on termination of their appointments). They are unlikely, however, to conclude that the financial rewards of accepting a part-time appointment match the unlimited personal and reputational liability exposures which they may face in the event of a serious claim.

Seeking input as to the adequacy and terms of these protections is recommended

That being so, well-advised individuals will inevitably wish to consider the suite of protections available to them in the event that their conduct is called into question. Perhaps 'suite' may be too grand a word in this context. The only two protections generally available to directors are directors and officers (D&O) liability insurance and company indemnification. Seeking professional input as to the adequacy and terms of these protections is certainly to be recommended and there is plenty to play for. But it is also perhaps worth being aware of certain inherent shortcomings in each of them.

GAPS IN D&O INSURANCE

- D&O insurance is designed to respond to liability for claims (including defence costs) which are made or investigations commenced against directors during a particular period of insurance. As such it provides limited, if any, protection in the absence of a claim or investigation against the individual concerned
- The insurance limits themselves are usually shared between a large group of individuals, which is rarely restricted to senior individuals (and often includes the company itself). Hence, the limits are prone to rapid depletion and even exhaustion
- Cover is often complex and comes with built-in restrictions and exclusions

What this means (among other things) is that D&O insurance is (a) not usually a resource dedicated to board members and (b) not available in circumstances where directors may feel the need for independent legal advice in the absence of a claim or of enforcement activity by regulators.

GAPS IN INDEMNIFICATION

- the company indemnity will be worthless in the event of company insolvency
- a director has no automatic right to indemnity
- such rights to indemnity as he or she may have may be further limited by:
  (a) statutory restrictions
  (b) the terms of any relevant contract (or deed poll)
  (c) the company's willingness and appetite to indemnify based on its perception of the facts in each case, regardless of any contractual commitment.

What this means is that directors (perhaps particularly in circumstances where they have left the company) cannot be sure (no matter how comprehensive their indemnity is) that it will always and in all circumstances be honoured by the bank.

DOES ANY OF THIS MATTER?

Despite all the fallout from the 2008 financial crisis, there have been very few examples of individual liability for corporate failures or losses. Moreover, in most cases the interests of the bank and its board are fully aligned. Quite apart from that, in order to attract and retain the right calibre and quality in their leadership teams, banks will naturally wish to offer every reassurance and resource to their boards – including the non-executives – to make them feel comfortable in discharging their roles. For so long as everyone's interests remain aligned (and the bank remains solvent), the answer is probably that none of this really does matter too much. The problem comes when interests of the individual and the entity begin to diverge. The danger is that this tends to happen just when a serious regulatory and/or liability issue arises. Whereas the bank will wish to navigate a course through such dangerous waters as quickly and safely as possible with minimum damage to its reputation, the individual will naturally be more concerned to protect his or her personal liability exposure and reputation.

The problem comes when interests of the individual and the entity begin to diverge

The danger is perhaps especially acute when the conduct of the individual is subjected to scrutiny long after he or she has parted company with the bank. In a regulatory context, that may now (as a result of changes brought by the Banking Reform Act 2013) be up to six years after they have left. If adequate attention is not paid to the potential for a later divergence of interest, the risk of a lack of funding for personal liability protection may be compounded by an inability to access the material on which any defence might otherwise be based. As the ancient Chinese proverb has it: "Make preparations before the rainfall. Don't wait until you're thirsty to dig a well."

Further information

Francis Kean has 25 years' experience as a litigation lawyer specialising in professional indemnity, financial institutions and D&O liability in the London insurance market. He was responsible for the launch of DARCstar, the first broker derived primary D&O form. It won the Insurance Innovation of the Year Award in 2012. He is the editor of a book called *D&O Liability Insurance*, published by The Insurance Institute of London, and is a frequent speaker at conferences and events.

Home comforts

NEW STATISTICS REVEAL BRITS ARE SAVING LESS THAN PEOPLE IN MOST DEVELOPED COUNTRIES. IT SEEMS AS THOUGH WE ARE LOSING THE HABIT OF PUTTING SOMETHING ASIDE. ARE HOUSEHOLD SAVINGS REALLY IN TROUBLE OR IS IT TIME TO CHANGE THE WAY WE THINK ABOUT THEM?

ANDREW DAVIS JOHANNA WARD

Back in 2014, the Tax Incentivised Savings Association launched a project to encourage more of us to get into the saving habit. The initiative, which includes representatives from 20 financial services firms, lists as the first of its seven objectives to help 'transition UK consumers from a culture of debt to one of savings'.

This goal – entirely understandable for an industry that makes its money by managing UK savers' funds – is one that many policymakers share. You don't have to look far to see why. Figures from the Office for National Statistics suggest that, by mid-2015, Britain's savings rate had fallen to 4.9%, very close to the long-term low it reached in 2008 as the credit-fuelled boom turned to financial meltdown. But not only are we British saving less than we used to, we are also saving less than most other developed countries. According to the Organisation for Economic Co-operation and Development, within Europe only the Greeks, Danes and Portuguese put aside less of their household income than we do.

More recently, there have been doomy headlines bemoaning an economic recovery fuelled by rampant consumer borrowing. It all starts to make sense: we're not saving because there's no point when interest rates are this low, and we can't afford to anyway because wages aren't rising much. Instead, we're spending more of our disposable income and taking advantage of dirt-cheap credit.

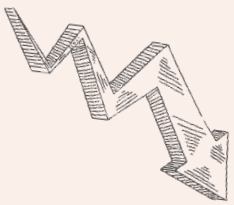
CLOSING THE GAP

But are we? As Chris Giles, the Economics Editor of the *Financial Times* pointed out in a wonderful column in January, the evidence says the opposite. Since 2009, households have added to their debts at less than a quarter of the rate that prevailed between 1997 and 2009. Moreover, he adds: "Official figures show that after deducting debt, net household assets stood at 7.67 times income in 2014, a stronger financial position than at any point in almost 100 years."

"There are clearly problems in the way we typically think about household savings"

So we are clearly not on another credit-fuelled bender, yet the household savings rate suggests we are losing the habit of putting something aside. Indeed, the whole point of the Government's drive to get as many of us as possible into workplace pensions through auto-enrolment (and talk of more generous relief on pension contributions for the less well-off) is that we need to close a savings gap that, left unaddressed, will condemn large numbers of people to a grim retirement of dog food by candlelight. This makes obvious sense: given what's happening to average life expectancy, there is a clear need to enable and encourage people to build up larger pension funds. So do we have a savings problem in this country or don't we?

There are clearly problems in the way we typically think about household savings. As Giles explains, if you look at both the asset and liability sides of our collective balance sheet, things look uncommonly healthy, largely because many of us own large sums of equity in our home during a period when property prices have risen in most parts of the country. If, instead of



looking simply at liquid savings, we thought of all household assets, including people's main homes, as 'savings', then the dismal ratios that place Britain near the bottom of the league would start to look rather different. Perhaps the savings rates that tend to be quoted in the media are less of a problem than we might suppose. This suggestion was made (implicitly at least) by the Work and Pensions Select Committee in a report published towards the end of last year. Delivering its judgment on the first few months of the Government's vaunted pension freedoms, the MPs called for consumers to be offered a much more holistic way of looking at all their savings and assets in a single view, including the equity built up in their homes. Underlying this is a growing realisation that as people are living longer, housing wealth is going to play a far bigger role in financing their lifestyles in retirement and in meeting the costs of later-life care for those who need it. This also explains why sales of equity release products are growing so strongly – up 21% in the second half of 2015 – and why the market is attracting serious attention from companies such as Legal & General.

ON THE HOUSE

But total lending is still tiny by comparison with the mainstream mortgage market. There is much further to go before illiquid home equity can genuinely be transformed into liquid savings. I have no doubt that in time it will be, and no doubt also that even when it is, serious issues will remain. Enabling housing equity to be treated as a pool of savings is no help to those who don't own property, and many younger people fear they will remain part of that group.

Claiming that housing wealth is the answer to our savings problem is appealing but wrong. But it is part of the answer.

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