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November 2012

Progress Update - Move to the new UK financial regulatory structure

Status of the Financial Services Bill, draft secondary legislation and policy statement on designation of investment firms

Financial Services Bill ("FS Bill")

Very broadly, the Bill brings forward the Government's core reforms to establish a new "twin peaks" structure, in which prudential and conduct of business regulation will be carried out by two new regulators (namely the PRA and the FCA), and also to establish the Financial Policy Committee ("**FPC**") within the Bank of England as the UK's macro-prudential authority.

The Government introduced the new legislation by amending the Financial Services and Markets Act 2000 ("**FSMA**"), as this was considered to be the least disruptive route for the market. A consolidated version of FSMA was published in February 2012. It had its first reading in Parliament on 26 January 2012, and is now at the report stage in the House of Lords (in which detailed, line by line examination of the bill takes place). Following the report stage, the bill will move to a third reading in the House of Lords for the final chance for the bill to be debated and amended. It is anticipated that it will receive royal assent by the end of the year.

The latest version of the FS Bill was published on 25 October 2012, along with explanatory notes, and it appears that the FS Bill has survived its passage through the House of Lords so far relatively intact, particularly in so far as the more controversial powers that are being bestowed on the regulators are concerned. Click here for our previous update in September 2012 that summarises these powers.

Legal cutover to the new regulatory structure is anticipated to be in April 2013.

Secondary legislation

Although the FS Bill puts in place the statutory framework for the new regulatory structure, secondary legislation to be made under the FS Bill will provide much of the detail that is required for the new regulators to carry out their roles on a day to day basis. So far, Treasury has published for consultation five draft orders, covering:

> the allocation of regulator responsibility between the PRA and the FCA, under article 22A of FSMA (the "**PRA Order**");

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> the threshold conditions for the PRA and the FCA that authorised persons must meet to become authorised (the "**Threshold Conditions Order**");

> the transfer of regulation of mutual societies to the PRA and FCA;

> the regulators' power of direction and information gathering over parent undertakings of authorised persons, UK recognised investment exchanges and clearing houses (the "**Parent-undertaking Order**");

> the power under s234B of FSMA to designate bodies that can make super-complaints about the impact of the market in the UK for financial services on consumers;

> the allocation of responsibility for rule-making with regards to the Financial Services Compensation Scheme between the FCA and the PRA.

Some commentary on the PRA Order, the Threshold Conditions Order and the Parent-undertaking Order is below.

PRA Order

The FS Bill provides that Treasury may specify activities that fall within the PRA's regulatory remit. This is to make the perimeter of the new regime responsive to changes that may be required in the future (e.g. as the result of international agreement or in response to innovation in the financial sector). From previous papers, an example of an area where the PRA might look to draw within its regulatory net is shadow banking activity (in whatever form that might take). The draft order provides that for now, deposit taking, effecting and carrying out contracts of insurance and Lloyd's market related activities will fall to be regulated by the PRA, which is entirely consistent with the proposed policy to date.

The effect of the draft order is that anyone carrying out these PRA activities will have to be authorised by the PRA, although the consent of the FCA will also be required. The PRA in addition has the power to designate investment firms to be prudentially regulated by it, where the PRA considers it desirable, in light of its objectives. This may be appropriate where a firm's activities give rise to a risk to the stability of the financial system by reason of its complexity, or interconnectedness with other firms. Again, this additional power should not come as a surprise to the market since it is entirely consistent with the government's policy to date, as stated in previous consultation papers.

Broadly, to be eligible to be designated by the PRA, the order provides that a firm must:

> deal as principal in investments; and

> have initial capital of at least €730,000.

Where the firm is a member of a group, the PRA must also have regard to the assets of the group. In this case, the PRA will look at the assets of group members who also satisfy the dealing and initial capital requirement set out above, and will consider in particular whether the firm's activities could have

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an impact on the PRA's ability to promote safety and soundness of these other PRA-authorised entities in the group.

The BoE and the FSA are consulting on a draft statement of policy to provide more detail on the designation criteria the PRA must employ, and also the procedural requirements for making a decision. Consultation closes on 4 January 2013. In summary, the PRA will look to designate the largest in size investment firms, and in particular, the PRA must have regard to whether:

> a firm's balance sheet exceeds £15 billion total gross assets over four quarters, and/or whether the assets of all eligible firms in a group exceed this £15 billion threshold – this size threshold is meant to be indicative of systemic significance, and is referred to as a "convenient reference point" - it does not mean that all firms with balance sheets of this size will be systemically significant, and the PRA will also look at business model and booking practices as well as other assets not submitted on the balance sheet (e.g. intra-day and end-of-day); and/or

> the sum of the balance sheets of all eligible firms in a group exceeds the £15 billion threshold – this is to ensure that groups do not structure themselves to avoid designation as a firm by spreading business across firms within the same group; and/or

> where the firm is part of a PRA regulated group, whether the firm's revenues, balance sheet and risk-taking is significant relative to the group's revenues, balance sheet and risk-taking – this relates to the requirement for the PRA to have regard to the impact of any investment firm on any PRA-authorised person within the group. The PRA will typically consider the materiality of a legal entity to its group with reference to its share of the group's revenues, balance sheet or risk taking, although this will be a question of judgement for the PRA based on knowledge of the group.

In relation to the procedure for designation, the PRA must give firms notice of its intention to designate a firm, and firms also have rights under the order to make representations to the PRA and to refer any decision to the Upper Tribunal.

Threshold Conditions Order

The threshold conditions set out in schedule 6 of FSMA are a statement of the minimum requirements with which a firm must comply in order to become authorised and remain authorised. Treasury has amended them however, it says, to better support the new regulators' judgement-led and forward-looking approach to supervision, as well as to reflect the existence of the PRA and FCA as two new regulators. We can therefore expect the threshold conditions to play a much more central part in the PRA and FCA's supervisory approach than they have done in the past for the FSA. Broadly, the amendments provide:

> separate sets of threshold conditions for the PRA and the FCA respectively;

> a "clear and unambiguous statement" of the standards that firms are required to meet and upon which the regulators will base their judgements;

> support to the regulators' respective objectives (e.g. the FCA specific conditions are more attuned to a firm's vulnerability than the PRA's are, and the PRA's focus more on capital and liquidity considerations).

In respect of the FCA and PRA specific thresholds, the order now provides, rather confusingly, for separate sets of thresholds for firms that are:

> authorised and regulated by the FCA only;

> FCA-specific thresholds for firms authorised by the PRA and subject to dual regulation;

> PRA-specific conditions for insurance firms; and

> PRA-specific conditions for banks and dual-regulated firms.

In terms of the content of the threshold conditions in the draft order, they have been mostly brought forward with some tweaks to support the PRA's or FCA's particular objectives as appropriate. For example, the current "adequate" resources conditions have been amended to provide that a dual-regulated firm must have "appropriate" financial resources to ensure that both good quality and sufficient in quantity resources are available to a firm.

There are also some entirely new conditions. For example, there is a new condition proposed that a firm must be capable of being supervised effectively. This is in regard to all circumstances, e.g. the way it is organised, the complexity of its business and its products. This condition encompasses the existing close-links condition, and applies to both dual-regulated firms and FCA-regulated firms. Click here for a table setting out the new threshold conditions and contrasting them against the existing ones.

Parent-undertaking order

Currently the FSA has limited powers over unregulated entities within group structures where some of the undertakings are regulated, and the problem is particularly acute where a group has an unregulated parent undertaking. All the FSA can do in these circumstances is seek to influence the parent by imposing a requirement on those entities within the group that are within its regulatory remit. The FS Bill therefore rectifies this situation by including a power for the regulator (which can be either PRA or the FCA) to take action in relation to an unregulated parent undertaking that exerts control over a regulated entity.

A regulator may only exercise this power, however, on the satisfaction of certain conditions, to provide some checks and balances against what otherwise could be seen as a draconian and potentially intrusive power. Specifically the power may only be exercised against parent undertakings that:

> are incorporated in the UK or have a place of business in the UK; OR

> are themselves a financial institution of a type that is prescribed in the order, e.g. a financial holding company, a mixed financial holding company (a financial conglomerate under the Financial Conglomerates Directive[1]) or an insurance holding company; AND

> the regulator considers that the acts or omissions of the parent undertaking are having or may have a material adverse effect on the regulation by the regulator of authorised persons; OR

> the appropriate regulator regulates on a consolidated basis some or all of the members of the group under EU directives as listed in the order, including the Banking Consolidation Directive[2], the Financial Conglomerates Directive, the Capital Adequacy Directive[3] and Solvency II[4].

Wheatley Review of LIBOR: Update on revisions to the FS Bill

As well as providing the architecture for the new financial regulatory structure, the FS Bill is also being used as the legislative vehicle to implement some of the proposals of the Wheatley review on LIBOR.

LIBOR is the London Interbank Offer Rate, and is the average interest rate estimated by leading banks in London that they would be charged if borrowing from other banks. George Osborne commissioned a review of the LIBOR setting process in July 2012, following LIBOR enforcement cases that revealed that it was common practice amongst employees to make requests to the bank's rate setters as to an appropriate LIBOR rate, often to secure a good outcome for the bank. Martin Wheatley was appointed to head up the review.

Treasury published a discussion paper on LIBOR in August 2012 that set out proposals for reform of LIBOR, reflecting the review's work. These proposed reforms to the LIBOR setting mechanism, as well as making LIBOR related activities such as setting and administering LIBOR regulated activities within FSMA, bringing managers responsible for LIBOR related activities within the scope of the approved persons regime, and extending the FSMA criminal misleading statements or practices regime under s397 to bring LIBOR under this regime, something which it is not able to do currently.

The final report was published in September 2012, and broadly concludes that:

> administering LIBOR and submitting to LIBOR become regulated activities under the FSMA Regulated Activities Order 2001 ("**RAO**");

> the approved persons regime extends to managers of the LIBOR submitting and administration process within firms;

[1] Directive 2002/
[2] Directive 2006/48/EC
[3] Directive 2006/49/EC
[4] Directive 2009/138/EC

> the FSMA misleading statements and practices offence is extended to enable the FSA (and its successors) to prosecute manipulation or attempted manipulation of LIBOR;

> responsibility for LIBOR should be transferred from the BBA to another administrator (to be appointed via a tender process);

> contributors to LIBOR should comply with guidelines set out in the final report, and the new administrator should introduce a new code of conduct.

If the Government accepts these proposals, amendments will be made to the FS Bill and the RAO, in time for the FS Bill coming into force and the legal cutover in 2013. Changes to the FSA's rulebook will also need to be made in respect of the approved persons regime. Both sets of these amendments will need to be consulted on, and so we can expect to see consultation papers in this respect over the next few months.

Approach Documents

Journey to the FCA

As John Griffith-Jones (FCA Chairman-Designate) says in his foreword to the FCA document, the purpose of the document is to "set out how we will approach our regulatory objectives; how we intend to ensure that firms put consumers at the heart of their business". It is not just the emphasis on consumer protection that is repetitive in the paper – much of the content reiterates the FCA approach document that the FSA published in June 2011[5], taken with subsequent speeches that have been published on the FCA's proposed regulatory approach (in particular those of Martin Wheatley on 16 and 17 October 2012 to launch the FCA approach paper)[6], we can therefore continue to expect the FCA to be guided, broadly, by the following considerations:

> ***Broad outcomes***: to seek the following broad outcomes: consumers get the financial services and products that meet their needs, from firms they can trust, markets and financial systems are sound, stable and resilient, with transparent pricing information and firms compete effectively, with customer interests and integrity at the heart of their business;

> ***Senior management***: to increase the FSA's existing focus on senior management by looking to senior management to lead by example and set a culture of compliance within their organisation – the paper states "we will increase our focus on the conduct at the very top of firms";

> ***Consumer focus***: to focus on the consumer, and in particular to look to the six retail consumer outcomes that were set out in the Treating Customer's Fairly Initiative to guide regulatory decisions and actions –

5 http://www.fsa.gov.uk/pubs/events/fca_approach.pdf
6 See: http://www.fsa.gov.uk/library/communication/speeches/2012/1016-mw.shtml
http://www.fsa.gov.uk/library/communication/speeches/2012/1017-mw.shtml

there is much reiteration in the paper and Martin Wheatley's speeches of the phrase "putting consumers at the heart of [a firm's] business";

> ***Forward looking, better informed and early intervention***: to gather information to identify risks sooner, and to intervene earlier where problems are identified that could cause consumer detriment or harm the integrity of the market;

> ***Policy-shaping***: to continue to play a part in shaping European policy through its membership of the European Securities Markets Authority ("**ESMA**");

> ***Judgement led supervision***: to carry out judgement led supervision.

Exercise of new duties and powers

Whilst the FS Bill sets out the new powers and duties that the FCA will have under statute, the FCA approach paper provides some (albeit slightly limited) comment on how the FCA intends to exercise its powers and discharge its duties. The FCA will have the following broad approach:

> ***Financial stability***: the FCA will have a financial stability objective of ensuring the "soundness, stability, and resilience" of the UK system. In respect of resilience, the FCA will expect high standards of operational risk management within firms and sound business continuity policies and procedures;

> ***Wholesale conduct***: an overarching strategic objective of ensuring that relevant markets function well, and as stated in the June 2011 FCA Approach Document, a renewed focus on wholesale conduct. This is in recognition of the interconnectedness of the wholesale and retail markets and the effect that poor wholesale conduct can have on retail markets - a more "assertive and interventionist approach" will be adopted and the FCA will "act to protect a wider range of client relationships than at present". Martin Wheatley reaffirmed this approach in a recent speech: "we will take a more assertive and interventionist approach to risks caused by wholesale activities";

> ***Product governance***: increased focus on product governance to pre-empt wide-spread harm to consumers – for example, the FCA will use information gathered to intervene earlier at the inception of a product, and greater scrutiny of how firm's design, operate and sell products – the work of the FSA looking at retail product development and governance in the structured product review is an example of such work. The FCA will also go further than the FSA has previously in the area of price governance by challenging the pricing structures of products and their value for money, previously relatively unchartered territory for the FSA;

> ***Product intervention***: the FCA will be able to make product intervention rules to prevent consumer detriment, all as proposed in the FSA's draft statement of policy for temporary intervention rules. For example, restricting the use of specified product features. Where the

FCA considers it appropriate, such rules can be made without consultation, although they will have a limited life of only 12 months. The FCA can also make rules to ensure the return of their money if they are sold a product whilst a ban or restriction is in force. To alleviate firm concerns that the FCA may step in to ban new products that have received a lot of investment from a firm, Martin Wheatley recently stated in a speech that “if you have done the right design work, tested how the products will work, and put in place sensible and appropriate distribution methods, we will not need to step in”;

> ***Product pre-approval***: although the FSA previously consulted on product pre-approval powers for the FCA and rules them out for now (on the grounds that significant extra resources would be required), the paper states that “product pre-approval may have a place in particular circumstances”. This is a clear marker that the FCA may re-visit this issue;

> ***Financial promotion bans***: a power to ban misleading financial promotions, along with details of the process that will be used when the FCA plans to use it. In relation to how the FCA intends to use the power, the paper indicates that this is an area where the power will be used to its full: “the promotions where we use the power will not only be the worst cases, and we will not always measure harm to consumers in terms of actual or potential financial loss”;

> ***Consumer credit***: the Government will make its final decision regarding transferring consumer credit regulation from the Office of Fair Trading to the FCA in 2013;

> ***Competition***: the FCA has a competition objective and duty that requires it to identify and address competition problems and use a more pro-competition approach to regulation. This new duty has been somewhat controversial and there is scepticism amongst the industry as to whether the FCA is well placed to pursue this objective. It is telling that the paper contains the least information about how the FCA will discharge this duty as compared with other duties, and indeed states that “ we are in the early stages of developing our approach”. To fulfil its duty the FCA recognises that it needs to expand its analysis of markets with a view to designing “pro-competitive” remedies, and “we will need to develop our skills and expertise in competition”. The FCA invites views on its competition related proposals in the paper. Martin Wheatley refers to the competition objective in a speech, and part of this work has involved undertaking a review of the authorisation process for new firms so as to ensure that there are no obstacles to new entrants with good business models, the results of which are to be published at the end of the year;

> ***Co-ordination with the PRA and Bank of England***: as Martin Wheatley confirmed in a recent speech “our relationship with the PRA will be crucial to the success of twin peaks regulation. This is going to be a very important relationship for us and both Andrew Bailey and I

will put a lot of effort into making that work". This provides some comfort in an area that has been of great concern to firms, although detail on how the co-ordination will work on a day to day basis is somewhat lacking (inspite of the publication of the Memorandum of Understanding between the PRA and FCA and Draft Annexes for the FCA/PRA MoU in January 2012).

FCA authorisation and supervisory processes

The paper sets out some detail on how the FCA will go about its day to day business of authorising and supervising firms, the key aspects are summarised below:

> ***Grandfathering***: firms and individuals that are already regulated by the FSA will be automatically transferred to the appropriate regulator as from the legal cut over date (likely to be in April 2013, according to Lord Turner). There will only be one register for firms, as there is now, that will be able to be accessed via the PRA and FCA websites;

> ***New authorisations***: FCA regulated firms will be assessed for conduct and prudential issues, and against the FCA threshold conditions. A new Business Model threshold will require the FCA to look closely at the proposed business model and the firm's viability in the medium term. Firms must be able to demonstrate adequate contingency planning, as well as how their business model meets the needs of their clients and does not place them or the wider financial system at undue risk. The FCA will assess dual-regulated firms for conduct issues only (with the PRA focussing on prudential issues);

> ***Approved persons***: for persons applying for significant influence functions in higher-impact firms, the FCA will continue the FSA approach of using SIF interviews where appropriate. The FCA are prepared to approve persons that have non-financial convictions that are spent. For dual regulated firms the PRA will approve the most senior functions – e.g. CEO or other senior directors. The FCA can give or refuse its consent to these applications. See paragraph below in relation to the FSA's consultation on changes to the approved persons regime for dual-regulated firms, published in October 2012;

> ***Change in control applications***: for dual-regulated firms these will be assessed by the PRA, who must consult the FCA before making its decision on approval. The paper states that the FCA will not accept a change in control application where "we have significant concerns about the controller's integrity or reputation". A different approach will be adopted where the proposed controller is known to the FCA and there are no issues with them. The FCA will enforce breaches of the change in control legislation in FSMA, including bringing prosecutions e.g. where they are not notified prior to the change in control taking place;

> ***Passporting***: the FCA will manage all firms passporting into the UK except banking and insurance firms. For firms passporting out of the

UK, the FCA will make relevant notifications for FCA authorised firms. For dual-regulated firms, the PRA and the FCA will communicate with the relevant EEA regulators.

On-going supervision of firms by FCA

> ***Broad supervisory approach***: very broadly, the paper confirms that the FCA will carry out more intensive supervision of those firms that pose the greatest risk to the FCA's objectives, this means that there will be fewer supervisors allocated to specific firms which will free up resource to carry out reviews of particular sectors or markets;

> ***Judgement based supervision***: the paper explains that this means that the FCA "will be making supervisory judgements about a firm's business model and forward looking strategy and will intervene where they see unacceptable risks to the fair treatment of customers";

> ***Categorisation of firms***: the FCA will categorise each firm into one of four conduct supervision categories, C1, C2, C3 or C4 respectively, according to the potential impact on the FCA's objectives. A C1 firm is broadly, a banking or insurance firm with a very large number of retail customers or a universal bank with large trading operations and client assets. A C2 firm is a firm in any sector with a significant number of retail clients or a large wholesale firm. A C3 is a firm in any sector with retail customers or a wholesale presence. A C4 is a smaller firm, and will include most intermediaries.

> ***Supervisory model***: this is to be based on three pillars:

- a new risk assessment framework called the Firm Systematic Framework that will replace Arrow;
- event driven work that will allow the FCA to deal more quickly with problems that emerge; and
- intensive campaigns on sectors of the market or products within a sector that put or may put consumers at risk.

The latter will be driven by sector risk assessment, essentially what is currently or likely to cause consumer or market detriment, using market intelligence and analysis and working with the FCA's new Policy, Risk and Research unit. Martin Wheatley recently referred to this new style of supervision as "more flexible" and that the new unit "will bring together our information-gathering, analysis, research and policy-making functions in one place".

The Firm Systematic Framework will differ from Arrow in a number of ways, including that it will provide continuous assessment of C1 and C2 firms (as opposed to point-in-time assessment, and follow up work should be carried out by the firm with greater use of s166 FSMA powers by the FCA (see paragraph on enforcement powers below). As succinctly summed up by Martin Wheatley, there will be a move from "a cycle of going round firms and kicking the tyres" to identifying and tackling problems before they cause widespread harm.

Enforcement powers and duties of FCA

> ***Credible deterrence***: it will largely be "business as usual" for the enforcement function once the FSA's powers are transferred to the FCA next year. The paper confirms previous statements by the FSA that the focus on credible deterrence will remain, with a continued focus on securing tougher penalties and greater consumer redress. Martin Wheatley also refers to "keep[ing] up our policy of credible deterrence, pursuing enforcement cases to punish wrong doing. The FCA will continue to pursue individuals (particularly senior managers) and criminal prosecutions will continue unabated. The FCA will also pursue initiatives announced by the FSA in recent speeches to ensure that firms cannot be used to facilitate financial crime. The tone in the paper is that the FCA's enforcement function will build upon the significant success of the FSA's enforcement work in recent years since the financial crisis in 2008;

> ***More informed approach***: going forward, the FCA's enforcement team intends to work more closely with other FCA departments, such as the Market Monitoring and new Policy, Risk and Research teams, to be better informed to take faster action against suspicious market activity and to prevent risks to consumers from materialising. This will include action against firms whose business model or culture, in the FCA's opinion, threatens the market. Early evidence of this can be seen in the FSA's recent guidance consultation on the risks to consumers from inappropriately structured incentives schemes;

> ***S166 FSMA powers***: the FSA has increasingly over the last few years looked to its powers under s166 FSMA to require firms to provide it with a skilled persons report (often that of an accountant or law firm) in respect of a particular aspect of its business. We have seen that these powers have been exercised often as a precursor to an enforcement case. The paper confirms that the FCA will make more use of these powers;

> ***Publication of warning notices***: there has been much discussion in recent months of the potential impact of the FCA's new power to publish warning notices. The FCA wishes to bring greater transparency to enforcement proceedings by using the publication of warning notices to bring potential problems to the attention of the public sooner. It also argues that early publicity will allow the FCA to highlight what it considers to be unacceptable behaviour, notwithstanding the fact that the party under investigation will not at that stage have exercised its right to reply nor will a final decision have been taken. The paper, however, goes even further in suggesting that the FCA will "to the extent that it is legally possible" publicise cases where it has intervened but in which no formal action has been taken. This stance raises a number of questions. The risk of reputational damage to firms (and in particular individuals) posed by the FCA's drive for greater transparency will be further exacerbated if parties are no longer able to keep confidential the details of FSA investigations which failed to

uncover any regulatory breach. Further clarity on the FCA's exact intentions here would be welcome as this is potentially fertile territory for a future challenge to the new regulator;

> ***Investigations of dual-regulated firms***: the paper indicates that the FCA will consult with the PRA before taking action against dual-regulated firms. Investigations maybe conducted by the FCA alone, jointly with the PRA or, in limited circumstances, separate but co-ordinated investigations may occur. This suggests that, on the admittedly rare occasion on which an alleged regulatory breach has a prudential angle, there is at least the potential for dual-regulated firms to find themselves simultaneously fighting on two fronts.

Yet to come

> A discussion paper in the first quarter of 2013 on "regulatory transparency" - in particular, how greater transparency in how firms deal with their customers, and more transparency from the FCA itself, can be embedded. This is certainly not a new topic, indeed the FSA published a discussion paper on transparency as a regulatory tool in May 2008[7], and it is clear that the FCA will be revisiting it.

> Further details on how to set out super-complaints and what the FCA will do with them once they receive them in early 2013.

> FCA to consult on high level proposals for consumer credit regulation in early 2013, and on the details of the regime in autumn 2013.

> Consultation on how the FCA will apply its Business Model Threshold Condition to be published in November 2012.

> High level timetable on roll out of Arrow replacement, the Firm Systematic Framework, to be published early next year.

> The future independence of the Regulatory Decisions Committee ("**RDC**"), the body which currently makes decisions in respect of contested enforcement (and other) matters on behalf of the FSA, has been called into question by proposed amendments to the FS Bill. The FS Bill will allow a member of the investigating team to form part of the RDC in contested cases, arguably compromising its current independence. This has prompted suggestions that the RDC may be replaced by a new decision making body. The paper confirms that the RDC will remain and that any decision to change the current decision making procedures will be taken by a future FCA board and be the subject of further consultation. It appears that the decision as to the future of the RDC has, for the time being, been postponed, with a public consultation on changes to the current procedure possibly following after next year's transfer of power.

[7] See: http://www.fsa.gov.uk/pubs/discussion/dp08_03.pdf

The PRA approach document

As with the FCA approach paper, there is much in this paper that is repetitive of previous papers, in this case the FSA's/BoE's approach paper published in June 2011[8]. We can therefore continue to expect the PRA to adopt the following broad approach to its duties:

> ***Safety and soundness***: the PRA's main remit as a prudential regulator will be to promote the safety and soundness of firms and to minimise the adverse effect of a failure of a firm on financial stability – as in previous papers, the paper emphasises that this does not mean the PRA's remit is to ensure that no firm fails, but to ensure that any failure does not lead to disruption in the provision of essential financial services (e.g. depositor's ability to make payments);

> ***Judgement led***: as with the FCA, the PRA will rely significantly on judgement – e.g. the PRA will judge whether firms are safe and sound and whether they meet and will continue to meet, the PRA specific threshold conditions. Supervisors will decide which risks are the most concerning and must be addressed;

> ***Forward looking and interventionist***: the PRA will adopt an approach that looks to the future to assess not just current risks but also those that could arise in the future. Early intervention where necessary will be a hallmark of its approach. Firms are urged in the paper to be open and co-operative in their dealings with the PRA;

> ***Senior management***: similar to the FCA's proposed approach and indeed the FSA's current approach, the PRA will look to the senior management of a firm to manage their firm prudently to maintain its safety and soundness, and that they establish a culture within their firm that supports this;

> ***Intensity of supervision***: this will vary across firms, depending on the PRA's assessment of the risk that a firm poses to the stability of the financial system;

> ***Co-operation with Bank of England, FCA and internationally***: the PRA will co-operate closely with the FCA and also with the rest of the BoE. The BoE, and in particular the FPC, will help inform required PRA directions, and so there will be a frequent two-way flow of information between the PRA and the FPC. The PRA will also co-ordinate internationally with its counterparts on both individual firms and on general policy. The detail in the paper on co-ordination particularly between the PRA and the FCA is still lacking and this is an area that is causing concern in the market – the concern being that the FCA and the PRA's remit will overlap resulting in a double regulatory burden for firms, or worse, underlap, leaving an area of vulnerability.

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8 http://www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pra_approach.pdf

The PRA's approach to its safety and soundness objective

Whilst previous papers and speeches have repeated the message that the PRA will have as its main remit the promotion of the safety and soundness of firms, the paper contains some detail on how the PRA will in practice approach the discharge of this objective. Examples include:

> although it will not be the PRA's remit to ensure that no firm fails, the PRA will require from all firms "a certain level of resilience against failure";

> the publication of policies by the PRA to advance its safety and soundness objective, which it will expect firms to meet "in the spirit as well as the letter";

> the PRA will assess a firm's safety and soundness against its own statutory objective and the PRA threshold conditions (e.g. have an appropriate amount of capital and liquidity, have appropriate resources to measure and manage risk, be fit and proper and conduct their business prudently). Rules will also set out requirements that must be met in order for its business to be conducted in a safe and sound manner.

How the PRA will identify risks to safety and soundness

> ***Categorisation of firms***: the PRA's approach will be premised on how it perceives the risks that individual firms pose to financial stability. To perform that assessment, the PRA will divide the firms its supervises into five categories, depending on their perceived potential impact. Category 1 will encompass the most significant deposit-takers, investment firms or insurers who will receive the most intense supervision, and whose size, interconnectedness, complexity and business type mean there is potential for very significant disruption to the UK financial system should they fail or carry out their business in an unsafe manner, down to category 5, which include firms where there is almost no capacity to cause disruption to the UK financial system should they fail or carry out their business in an unsafe manner. This categorisation is to help the PRA determine the intensity of supervision for a firm and also flag those areas where a firm provides significant economic functions (e.g. payment, settlement and clearing etc). Numerical scoring based on a firm's regulatory reporting will provide a starting part for categorisation of a firm. Firms will be informed what category they have been assigned;

> ***PRA's assessment of risk***: the PRA will assess external risks facing firms (e.g. such as low interest rates, excess credit growth etc.) as well as business model analysis to understand risks to a firm's business model. This will be more detailed for those firms that pose greater risk to the financial system – e.g. the PRA's view as to the firm's likely prospects will impact on the amount of capital it is required to have. This assessment will also encompass peer analysis and whether the PRA is able to supervise the activities it carries out. If the PRA

identifies any barriers to it supervising a firm it will require remedial action.

Required measures to safeguard safety and soundness

The PRA will want to see that firms have in place adequate measures to safeguard their safety and soundness. Whilst many of these are more or less the same as those measures that the FSA expects firms to have in place (e.g. minimise incentives for risk taking, firms to deal with the PRA in an open manner, appropriate risk management and procedures etc.), particular emphasis is given to the following in the paper:

> ***Management and governance***: the paper emphasises the role of management in managing their firms prudently and states "this goes beyond complying with the letter of the PRA's detailed requirements …[(e.g. on capital etc)] and it will often mean firms acting more prudently that they would otherwise choose". The paper also focuses on board responsibility for ensuring that management is held to account in its conduct of the firm's business, as well as emphasising the fact that board responsibility is individual as well as collective. Whilst these are not new concepts, and we have seen the FSA take an increasing interest in the role of the board and its effectiveness in relation to management over the last few years, the particular emphasis in the paper suggests that the PRA will be paying boards even more attention;

> ***Culture***: the paper suggests that the PRA will pay particular regard to a firm's culture and whether it is consistent with its prudent management. Whilst the emphasis given to a firm's culture is not new - it has been referred to with increasing frequency by the FSA in the last year, the tone of the paper suggests that this is an aspect of the firm's business that the PRA will pay more attention to than the FSA has previously. In particular, the PRA will look to a firm's senior management to take responsibility for "establishing, embedding and maintaining the culture";

> ***Regulation of groups***: in groups that contain non-PRA regulated firms, the PRA will expect any non-regulated firms to nonetheless have regard to the PRA's objective. The PRA will also expect to have extensive contact with unregulated holding company's senior management and board. Again, whilst this is not unfamiliar to firms currently regulated by the FSA, the paper goes a step further and applies these requirements to board and management of overseas firms that establish PRA regulated firms in the UK, and to the wider group more generally. The justification given for this is that "issues at the parent or group level could have an effect on the PRA-regulated entity and the PRA objective generally", and is consistent with the FSA's approach to extending the approved persons regime in the last couple of years (e.g. the FSA's plans to bring in the new CF00 function proposed in PS10/15, which were postponed in 2011);

> ***The PRA as an enforcer***: the paper makes a brief mention of the PRA's own enforcement remit. The PRA intends to use its powers to

secure ex ante remedial action in respect of emerging risks, to the extent that enforcement action to correct past wrongdoing should rarely be required. It will, however, have disciplinary powers which it may exercise where firms fail to comply with its directions. Further consultation as to the exercise of the PRA's disciplinary powers will take place before it begins work next year;

> ***Regulatory capital***: currently, banks and most investment firms are required to hold sufficient regulatory capital to meet their credit risk, market risk and operational risk capital requirements, otherwise known as Pillar 1 requirements, based on an 8% capital ratio of total capital to risk weighted assets. The calculation of risk weighted assets and capital requirements are calculated in accordance with the rules in the Prudential Sourcebook for banks and investment firms ("**BIPRU**") and the General Prudential Sourcebook ("**GENPRU**"). These rules are for the most part a copy out of the Capital Requirements Directive 2006, which is based on the Basel II rules;

> The PRA has confirmed in the paper that for all banks, building societies and PRA-designated investment firms, the minimum capital level will comprise the same three elements as the FSA currently requires, namely Pillar 1 capital, Pillar 2 buffer (e.g. the additional capital calculated by a firm yearly through its individual capital adequacy assessment ("**ICAAP**"), and intended to meet idiosyncratic risks particular to a firm's operations), and the capital planning buffer (known as Pillar 2B, which the FSA can impose on firms to build up a capital buffer). While stating that this framework will be revised in light of forthcoming changes in the Capital Requirements Directive/Regulation it does not give any detail on how the rules in BIPRU and GENPRU will change.

A few points are worth noting. Firstly, the PRA confirms that it will expect firms to comply not just with the criteria in GENPRU or the definition of capital, but also the "spirit" in structuring capital instruments - firms may not count capital instruments that breach the spirit. Secondly, as regards the location of capital, the PRA states that it will expect capital to be located in the regulated entities where it is needed. If the regulated entities had sufficient capital to meet their regulatory capital requirements but the PRA felt more capital was "needed", it is unclear how the PRA could compel an unregulated firm in the group to transfer capital to a regulated one, in particular if the unregulated firm was incorporated outside the UK. Thirdly, one quite substantial difference from the current practice of the FSA relates to the use of internal models. The FSA has given permission to a large number of firms to use internal models, as permitted by the Basel II rules. However, the PRA notes that it will be "generally sceptical that this approach (internal models) on its own, can provide an appropriate basis to calculate capital requirements", and will expect the model to be appropriately conservative. The PRA may also set capital floors or impose adjustments to the modelled capital requirement if they think necessary. Finally, the PRA will, as the FSA currently does, come to a judgement on the amount of supplementary capital required to cover risks not covered in Pillar 1, and can issue the firm with an Individual Capital Guidance ("**ICG**"). However, unlike the FSA which only updates the ICG annually, the PRA has stated that it may update the ICG "at any time". It is unclear what justification it would need to do so, and on what grounds.

> ***Liquidity***: the key elements of the current liquidity regime in BIPRU are self-sufficiency, adequacy of liquidity resources to meet both idiosyncratic and market stress events (of 30 days/3 months) and the build up of a high quality liquid assets buffer. The PRA will regulate liquidity in very much the same manner and format as the FSA does under BIPRU 13. The PRA does however confirm that these rules may change as a result of the CRDIV based liquidity rules coming into effect in 2015, and that as soon as is practical, it will outline a transition from the current regime to new international standards;

> ***Resolvability***: the PRA confirms in the paper that it will apply its resolvability requirements to firms incorporated in the UK, including subsidiaries of overseas firms. The PRA will also expect firms that operate as branches in the UK to have robust recovery and resolution plans in place. As regards the information that the PRA expects firms to provide, one key element of this is that it will require deposit takers to be able to produce a single, consistent view of each depositors funds (known as a "single customer view") to enable the Financial Services Compensation Scheme to implement rapid pay-out. In addition, where significant barriers or obstacles to resolvability are identified, firms will be expected to remove them. This may include changes to business practices or legal structures.

Supervision by the PRA

The paper provides some information on how the PRA will in practice conduct its day to day supervision of firms. The key points are:

> ***Risk assessment***: the PRA will carry out its assessment of firms and the risk they represent on a continuous cycle basis. As referred to in previous papers and communications, the PRA will carry out certain "core" supervisory activities, depending on the firm's category (e.g. more intensive supervision for the highest risk, category 5 firms). The lowest risk firms will be subject to a "baseline" level of supervisory activity. Beyond that little information is given as to the supervisory activities it will perform – "the PRA will not be formulaic about the supervisory activity it will perform, since the focus on key risks means that this will depend on a firm's particular circumstances";

> ***Supervisory activities and tools***: many of the activities that the PRA will be carrying out in a supervisory function are the same as those carried out today by the FSA e.g. information gathering through regulatory returns; it will carry out a broader range of information gathering activities than the FSA has done in the past - for example, as

well as looking at information in the public sector such as annual reports, it may also request firm-specific data (e.g. management forecasts etc). It will also conduct detailed on-site testing, e.g. focused reviews of a firm's proprietary trading, and may involve its risk specialists in stress-testing/other assessments. The PRA will make continued use of s166 reports and will be able to enter into contracts with skilled persons directly (unlike the FSA which only has the power to direct the appointment of a skilled person by a firm);

> ***Proactive intervention framework ("PIF")***: the paper gives more information about how the PIF framework will work in practice. The framework is to be put in place to ensure that the PRA identifies and responds to risks at an early stage. The PIF will be sensitive to risks faced by a firm and their ability to handle them (e.g. external risks, business risk, management and governance etc). There will be five "PIF" stages, stage 1 being "low risk to viability of firm", with stage 5 being a firm in resolution or being wound up. Every firm will sit in a particular stage at any point in time, and it will be reviewed at least annually or in response to relevant major developments. The PRA will not publicise to the market its judgement on a firm's proximity to failure. The PRA will also not for now disclose the stages to firms themselves in case this triggers a disclosure obligation under European legislation. The PRA and Treasury will discuss whether to ask for changes to the relevant European legislation. Aggregate statistics on the number of firms in each stage will be published annually;

> ***Risk mitigation***: there will be an annual internal meeting for firms to discuss risks they face, supervisory strategy and proposed remedial actions. Major decisions will be made by the PRA's most senior personnel. The paper emphasises that "there will be a clear and direct link between the risks that the PRA perceives and the actions it will expect from firms in consequence". For example, if the PRA has identified excessive staff remuneration, it will expect a firm to address it by e.g. making restrictions on payments;

> ***Outcomes based supervision***: as an outcomes based regulator, the PRA will point out areas of concern and the outcome it wants, but leave the firm to manage itself to achieve that outcome;

> ***Policy regarding formal use of PRA powers***: the paper states that "while the PRA will look to firms to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them an appropriate means of achieving its desired supervisory outcomes". In addition, it may, for example, refuse consent to a change of control request where it has safety and soundness concerns;

> ***Supervision of overseas firms operating in the UK - subsidiaries of overseas firms***: the PRA will treat such firms in an equivalent way to UK-owned firms, and so will apply full prudential capital

requirements. The PRA will also look to limit so far as possible interconnectedness with the rest of the group;

> ***Supervision of overseas firms operating in the UK – UK branches of EEA firms***: the PRA will focus on resolution planning, and co-ordinating with home state regulators to ensure access to information on the safety and soundness of the parent (since its powers and responsibilities are curtailed under EU law). Liquidity will be a particular area of focus, with the position of the whole firm being taken into account. Where concerns arise the PRA will liaise with the home state regulator, although it is permitted under EU law in emergency situations to take precautionary steps to protect depositors;

> ***Supervision of overseas firms operating in the UK – UK branches of non-EEA firms***: the PRA's authorisation will apply to the whole firm. The PRA will assess the adequacy of the home state regulator, and will only grant authorisation if it operates a broadly equivalent regime to the UK. For existing UK branches of non-EEA firms where the home country regime is not deemed to be equivalent, the PRA's supervisory work will focus on mitigating the risks of non-equivalency in certain areas, with a particular emphasis on financial strength of the whole firm, liquidity and resolution plan. For branches where the PRA is satisfied with the home country regime, the PRA will rely on the home country supervisor's prudential supervision, although the PRA will particularly look at liquidity and ensuring that there are senior individuals in the UK that are responsible for management of the UK business;

> ***Supervisory colleges***: for UK firms the PRA will organise and chair the supervisory college. It will be an active participant for all firms with significant operations in the UK. The PRA will publish on its website a list of colleges in which it participates, as well as cases where the lead authority has not invited the PRA to participate in a college in respect of a firm with significant UK operations;

> ***PRA as a policy maker***: as the FSA has done, the PRA will publish policy documents setting out what it expects of firms. The paper also notes the PRA's limitations on making policy in light of internationally agreed policy for supervision (e.g. through the Basel Committee etc) and European legislation;

> ***Staffing of the PRA***: the allocation of resources with the PRA is indicative of its risk based approach – approximately one-third of supervisory staff will be focused on the 20 or so firms with the highest potential impact, a further third will be focused on the next 70 most significant firms with the remaining focusing on the 1,500 or so lower impact firms. The highest proportion of senior and experienced supervisors will be responsible for supervising those firms that present the greatest risk to the financial system.

Transitional measures

FAQs published on the FSA website confirm details regarding the transition to the PRA, including:

> ***Register***: there will be one register maintained by the FCA, and existing FSA numbers will be carried across;

> ***Existing permissions and waivers***: (e.g. Part IV permissions, controlled functions, waivers and modifications, passports, limitations and requirements) are likely to be grandfathered without the need for a firm to take action. Secondary legislation will be published to effect this.

Yet to come

> Discussion paper on PRA's approach to regulatory data, November 2012.

> A statement containing further detail on the PRA's approach to supervision of overseas firms operating in the UK.

> A policy statement on the PRA's power of direction over parent undertakings.

> Consultation on regulatory tools.

> Consultation on the fee framework.

> Details of specific pieces of non-handbook guidance that will be adopted.

The Handbook

The FSA has published a one minute guide on the Handbooks for the PRA and the FCA that provides a helpful overview of what firms can expect at legal cutover. The guide provides that the handbook will be split between the FCA and the PRA to form two new handbooks. Most provisions of the existing FSA handbook will be incorporated into the PRA's handbook, the FCA's handbook, or both. Some amendments to the content of the rules will also be made to reflect each new regulator's set of responsibilities and objectives, and changes will be made to regulatory processes such as obtaining permissions, passporting, controlled functions etc. to reflect the responsibilities and powers of both regulators. The overall approach to amending the rulebook, however, is premised on the basis that only changes that are required to implement the FS Bill and support the creation of the new regulatory structure will be made. This is to minimise the degree of change for both the regulated community and the regulators themselves. More substantive changes will be consulted on before legal cutover.

Following legal cutover the PRA and the FCA will amend their own rules in line with their own powers and objectives, consulting and co-ordinating with one another where appropriate.

The new handbooks will be available on-line, and firms will be able to view:

> the PRA handbook, displaying provisions that apply to PRA-regulated firms;

> the FCA handbook, displaying provisions that apply to FCA-regulated firms; and

> in the transition, a central version that will show provisions of both handbooks, with labels indicating which regulator applies a provision to firms.

The new handbooks are expected to be published before the legal cutover, although no further indication on timetable is given. Of more concern, the FSA has stated that the existing FSA guidance is currently being reviewed, and that the PRA will only adopt non-Handbook guidance "where there is a strong case for this, in light of the PRA's objectives".

The PRA and FCA regimes for Approved Persons

Some detail on how the approved persons regime will work under the respective FCA and PRA regimes was provided in an FSA consultation paper published in October 2012 (consultation closing on 7 December 2012). The consultation paper also includes draft handbook text. Broadly the amendments seek to:

> divvy up the current list of controlled functions between the FCA and the PRA for dual regulated firms, to avoid duplication for these firms, and to reflect amendments made to the approved persons regime in the FS Bill - click here for a table showing the division for dual regulated firms; and

> extend the Statements of Principle in APER to a broader set of activities and their application to people approved by either regulator.

Whilst the FSA has gone to some lengths to ensure that firms do not have to make duplicative applications to both regulators in respect of functions, the solutions that the FSA has proposed in the paper are in some cases less than straightforward. It is also clear that the difficult question of whether senior managers of an overseas parent or holding company of an FSA regulated firm that exercise significant influence over the UK FSA regulated firm should be registered in a director role has not gone away and the paper makes it clear that the FCA will wish individuals that have a significant influence over a UK firm to be registered in the director role.

A summary of the key amendments proposed is below:

> ***Designation of PRA functions and FCA functions***: although the current split between significant influence functions and customer functions is being retained, the FCA will only be able to designate customer functions, and SIF functions for FCA regulated firms. For firms within these groups there will be very little change to how the approved person regime will in practice operate for them;

> ***Co-ordination between PRA and FCA for approval of dual-regulated firms***: the FCA and the PRA must consult each other before specifying SIFs in relation to dual-regulated firms. The PRA must obtain the FCA's consent before approving a SIF application for a dual-regulated firm;

> ***Withdrawal of approval***: either regulator may withdraw approval from a person who is carrying on a SIF at a dual-regulated firm (regardless of who initially approved the person);

> ***Enforcement***: each regulator can discipline an individual for breach of a statement of principle that they have issued;

> ***Statements of principle***: the statements of principle can relate to conduct of persons not just relating to their controlled function, but also in relation to other functions they perform where those functions relate to the firm for whom they hold their approval;

> ***Interaction between PRA and FCA functions***: the statutory obligation to avoid duplication for firms in the FS Bill has resulted in proposed arrangements of some complexity. The paper states that firms should not usually have to get dual approval from FCA and PRA, as the FCA may not designate functions that the PRA has specified. However, to deal with situations where a person would otherwise have to apply to the FCA and the PRA to carry out a combination of FCA and PRA functions, (e.g. a CEO being an executive director, both PRA and FCA functions respectively), the rules have been designed to ensure that dual approval from both regulators should not be necessary, and approval should be sought from the PRA only. The PRA approval will effectively expand to cover the FCA function as well. To streamline the application process, firms, when applying to the PRA for approval for SIF positions, will be asked if they need approval for any similar or corresponding FCA functions (e.g. non-executive director functions, director functions and apportionment and oversight). On approval, the PRA controlled function will include the FCA role. If however an individual steps down from the PRA function but continues with the FCA function, they will need to apply to the FCA for approval. Whilst firms will be grateful that steps are being taken to ensure that duplication on their part is avoided, they may find the solution in this case takes some time to become accustomed to;

> ***Changes to PRA functions - non-executive directors***: two new non-executive director functions will be created - one for the FCA and one for the PRA respectively. The FCA function will cover all that falls outside the PRA function (e.g. members of Lloyds' committees). The PRA function will cover anyone who performs the role of chairman, senior independent director, chair of the audit committee, the remuneration committee or the risk committee. If an individual moves within the function, e.g. from being chairman to chair of the audit committee, they are required to notify the PRA, though approval is not necessary. Any individual who moves from a PRA non-executive function to an FCA non-executive function, will need to apply to the FCA for approval;

> ***Changes to PRA functions – systems and controls functions and governing functions***: currently an individual applying to perform a governing function (other than non-executive director) does not need

separate approval to perform the systems and controls function. Going forward, an individual seeking approval for a PRA systems and controls function does not need to also apply for an FCA governing function. If they take up both positions at the same time, they need only apply to the PRA and declare the FCA role in the application. If the FCA role is taken up subsequently a separate application to the FCA will be required;

> ***FCA functions for FCA regulated firms***: these are being brought forward in the same format as now, except that the actuarial functions will not apply, as they will only be carried on in dual-regulated firms. Click here for a list of the FCA functions;

> ***How to submit applications***: following legal cutover firms should continue to submit the forms as currently used via the ONA system. Paper applications need only be submitted to the relevant regulator. For dual-regulated firms that are applying for PRA and FCA functions, they should apply to the PRA;

> ***Applications by dual-regulated firms***: as the FCA's consent must be obtained to the PRA's approval, both regulators may ask for more information when considering an application for a PRA function. Such requests will stop the clock on the statutory timeframe set out in the FS Bill. Where candidates are to be interviewed, both regulators will, where possible, conduct one interview, but reserve the right to conduct individual interviews;

> ***Fit and Proper test***: no substantive changes are being made to the fit and proper test as set out in FIT of the FSA handbook;

> ***Changes to statements of principle and code of practice for approved persons***: the FS Bill allows both the PRA and the FCA to issue statements of principle for conduct. In the case of the PRA, its APER will apply to those persons it has approved and in respect of dual-regulated firms, those persons whom the FCA has approved to perform a significant influence function. The FCA may issue a statement of conduct for persons approved by either regulator. The scope of the activities that the PRA's and FCA's APER will apply to will be extended beyond the function for which the person has been approved, and will relate to any activity that relates to the carrying on of a regulated activity by the firm that sought the approval (although in the case of the PRA this is refined slightly to apply to the activity which could be a significant influence function insofar as it relates to the carrying on of a regulated activity by the firm). Although the FSA acknowledges that this might be viewed as a significant change, in practice they expect that it will have little impact – for example, most approved persons would act with integrity regardless of whether they are carrying out their controlled function or not;

> ***Transitional provisions for Approved Persons regime***: the government has not published details of transitional provisions dealing

with how persons who are already authorised as approved persons will be treated, but the FSA makes the comment in the paper that it is currently their expectation that approvals held will be “grand-fathered” across to the appropriate regulator without need for any action on the part of the individuals concerned. Further details on this will be provided in the coming months.

Linklaters

Contacts

For further information please contact:

Michael Kent
Partner

(+44) 207 456 3772

michael.kent@linklaters.com

Peter Bevan
Partner

(+44) 207 456 3776

peter.bevan@linklaters.com

Nadia Swann
Partner

(+44) 207 456 5232

nadia.swann@linklaters.com

Carl Fernandes
Partner

(+44) 207 456 3002

carl.fernandes@linklaters.com

Sarah Parkhouse
Partner

(+44) 207 456 2674

sarah.parkhouse@linklaters.com

Harry Eddis
Partner

(+44) 207 456 3724

harry.eddis@linklaters.com

One Silk Street
London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com

Author: Kirsty Gibson, Allegra Miles and Sara Cody

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