FMConsult compliance solutions

2019 Regulatory Bulletin Issue 9

"I remain just one thing, and one thing only, and that is a clown. It places me on a far higher plane than any politician"

- Charlie Chaplin

The Financial Conduct Authority (FCA) is stepping up its efforts to ensure firms are aware of what they need to do to prepare for the potential of a no-deal Brexit. Firms who have not prepared appropriately may risk an impact on their business.

Is your firm prepared for Brexit?

If your firm conducts business in the EU you must have contingency plans in place for your business after Brexit. **If there is no deal on 31st October passporting will end on the day the UK leaves the EU.** If your firm is FCA regulated only, and you use a passport to operate in the UK, you will need to register for the Temporary Permissions Regime.

Generally the same rules and laws will apply after exit day and transitional relief will be provided. But in some areas the FCA will not provide this relief and Firms must take steps to be ready by 31st October 2019. If your firm is not ready to meet obligations in full, the FCA will expect to see evidence why this was not possible.

If you transfer personal data between the UK and the EEA you can read ICO's information on data protection and Brexit to help you understand if/how you will be affected.

If you are a UK firm servicing customers in the EEA you will need to decide what steps you need to take to continue to service your existing customers while following local laws and regulators.

Pay attention to your customers' needs and communicate with each group of customers affected by Brexit and explain how they are affected. You may see a rise in customer queries so be prepared so you can respond accurately, fairly and promptly.

Improving the suitability of financial advice

A Speech was given by Debbie Gupta, Director of Life Insurance and Financial Advice Supervision at the FCA. She outlined that there are 4 broad areas of work that the FCA are focusing on: improving standards; targeting firms that cause the most harm; supporting consumers; and helping advisers.

Her key message was that: "The foundation of suitable advice is getting to know your client and understanding their circumstances and motivations."

She emphasised the FCA's view that Advisers play an increasingly important role in the choices people make, and the impact of those choices on their quality of later life.

One of the main causes of unsuitable advice is where the risk level of the recommended solution does not match the risk the client is willing or able to take.

The FCA still see advice where the proposed solution is not aligned with the client's attitude to risk.

- If you're dealing with a client considering a DB transfer, the FCA expects you to consider investment risk. This can sometimes be a slight discrepancy in asset allocation. But the FCA also sees files where cautious investors are put into unregulated and non-mainstream investments.

The FCA expect to see an alignment between the client's attitude to risk and your recommendation, including an assessment of how prepared they are to give up a guaranteed lifetime income for one which comes with no guarantees about value or sustainability. Make your records clear.

- For a client considering a DB transfer you will also be assessing their attitude to transfer risk. The FCA consider this assessment should be binary: yes, they have the attitude to accept the risk of transfer, or no they don't. The FCA don't think the client's attitude to transfer risk can be measured in percentage terms or using a scale such as cautious, balanced or adventurous.

- Consider the limitations of the tools you use and the outputs they give. It's important that due diligence is undertaken of Third-party providers in order to understand the limitations of the tools provided. With such tools there's a real risk of miscalibration without such due diligence.

- Evidencing the client's attitude to risk should include separate assessments of all relevant factors, before they are combined to given an overall attitude to risk:
    - Attitude to risk – the client's emotive response to risk. How do they feel?
    - Capacity for loss – the client's ability to take risk. Can they afford it?
    - Risk need – do they need to take a risk to meet certain objectives? And should they?

The FCA's suitability rules require firms to consider clients' risk tolerance and ability to bear losses. So the FCA would expect to see this in every file. For example:

- The FCA have seen evidence that a client is heavily reliant on a product or investment to meet their income throughout retirement, and cannot afford to lose any value. But this was not evidenced as the clear driver for the recommended solution.

- 2 clients may have the same benefits from a DB scheme but very different financial circumstances. The client who has significant other assets has a higher capacity for loss. This is because the income from the scheme is one of many sources of income. The other client has no other assets and the DB scheme is their main source of income in retirement. Their capacity for loss would be very low. Capacity for loss in each case would be evidenced and assessed differently, even though the clients present as similar.

- Aim for consistency. The FCA would expect to see a clear link between the information given to the client such as asset allocation and the recommended funds/portfolio.

And finally, it's not just clients' knowledge and experience. It's yours too. So firms should acknowledge and recognise the limitations of their own knowledge - do you really

understand the products and services you may be recommending?

The FCA would expect to see evidence of the due diligence carried out on products and services to mitigate this.

FCA finds MiFID II research unbundling rules working well for investors

A key principle of the MiFID II unbundling reforms is to ensure that portfolio managers act as good agents in the best interests of their clients and that their investment decisions are not unduly influenced by third parties. From 3 January 2018, asset managers were required to pay for research separately from execution services, and either charge clients transparently or pay for research themselves. Prior to MiFID II, research costs were often 'bundled' into opaque transaction fees borne by investors' funds, with many firms not adequately controlling how much of their clients' money was being used to pay for research.

The FCA's review found that, following MiFID II, most asset managers have chosen to pay for research from their own revenues, instead of using their clients' funds. Firms have also improved their accountability and scrutiny of both research and execution costs, including where firms have chosen to charge research costs to clients. This has resulted in investors in UK-managed equity portfolios saving around £70m in the first six months of 2018 across a sample of firms.

The review and analysis also found that:

- since the introduction of the reforms, budgets set by firms to spend on research have fallen on average by 20%-30%
- despite these budget reductions, most asset managers said they are still getting the research they need
- research coverage of small and medium enterprises (SMEs) listed in the UK has not seen a material reduction to date, and
- research pricing is still evolving, with wide price ranges being offered by brokers and independent providers

Detailed findings in relation to asset managers' approaches to valuing research, and the FCA's expectations as to how certain activities, such as trade association events, research marketing and consensus forecasts, interact with the new rules can be found within the multi-firm review report. The FCA will continue to monitor both competition impacts and research coverage of SMEs following the MiFID II reforms by analysing market data and other reviews, such as the European Commission's forthcoming study. The FCA also intends to carry out further work in this area in 12 to 24 months' time to assess firms' ongoing compliance with our rules.

Meanwhile articles and research in the US – such as analysis by Evercore ISI indicate that US based firms outperform EU firms subject to MiFID II.

Preparing for Brexit in financial services: the state of play

Andrew Bailey, Chief Executive of the FCA, delivered speech at Bloomberg – London on 16 September 2019.

Andrew stated in his speech that one of the most important principles for wholesale financial markets is **best execution** for clients. Andrew further went on to say a principle like best execution does depend on the overall integrity of markets, which is one of the FCA's three statutory objectives along with consumer protection and competition in the interests of consumers. Integrity in financial markets requires definition – on its own it could become rather trite. There are 4 important and complementary component parts to the objective of integrity: that markets are orderly, resilient, transparent and clean in terms of not being used for a purpose connected with financial crime and not being affected by behaviour that amounts to market abuse. These principles transcend any particular set of rules, and they shape the outcomes that the FCA wants to see.

- Progress for preparation of Brexit.

The FCA continues to plan for all potential outcomes, and that of course includes the possibility of no deal exit. The largest part of the overall Brexit preparation work is for a no deal scenario, because it would involve the largest change in short order.

Main Developments:

- Legislation and the Temporary Transitional Power

Andrew mentioned that the FCA have been working closely with the Treasury and the Bank of England to make sure EU financial services legislation is effectively on-shored by Exit day.

The Temporary Transitional Power will give the FCA the ability to delay or phase changes to regulatory requirements made under the EU (Withdrawal) Act 2018. In the event of a UK exit from the EU without a transitional period, the FCA intends to provide a transitional relief period up to the end of next year.

- Memoranda of Understanding

The FCA have concluded new cooperation agreements with the EU markets, insurance and banking authorities which will take effect in a no deal outcome. These MoUs provide a framework for the sharing of confidential information, which will assist the FCA in carrying out our functions; allow UK or EU based firms to delegate or outsource certain activities to firms based in the other jurisdiction; and support future market access and equivalence decisions. The FCA have also agreed changes to 43 non-EU MoUs that we need to amend and expect to have all necessary MoUs signed by exit day.

- FCA activities

The FCA has an extensive programme of work to be ready within the FCA. That work is on track with the range of possible scenarios. The FCA will be taking on several functions in respect of the UK which are currently performed by ESMA at the level of the EU, notably regulation of Credit Rating Agencies and Trade Repositories. The FCA will also be taking on from ESMA responsibilities in respect of MIFID2.

The FCA has also launched new material designed to ensure that firms have the right information to allow them to plan for exit. There is a particular focus on material for small firms. Although, the FCA see larger firms more regularly, please also use the website as a source of useful information.

The FCA have also set up a Brexit information line for firms and are using social media to direct people to their website.

Issues that remain:

- The Share Trading Obligation (STO)

The STO is a rule in EU law that requires EU MIFID firms to trade certain shares only on EU venues, systematic internalises or equivalent third country trading venues. The UK has onshored the share trading obligation under the EU Withdrawal Act. The obligation applies to all shares traded on venues in the UK or EU, except where trading is non-systematic, ad hoc, irregular and infrequent. It is for the FCA and ESMA to regulate the scope of respective STOs. ESMA has stated that its trading obligation applies to the shares of all companies headquartered in the EU that are traded on a trading venue in the EU.

- The Derivatives Trading Obligation (DTO)

The EU's Derivatives Trading Obligations (DTO) requires EU firms to trade some classes of OTC derivatives on EU or equivalent third country Trading Venues. The DTO comes from a G20 agreement that both the FCA and the EU are committed to and which, outside the EU, through the FCA's work to onshore the EU acquis the UK will have implemented identically. This means that unless the UK and EU find each other's regulatory regimes as equivalent, EU firms will not be able to meet the EU's DTO by using UK trading venues to trade in-scope derivatives, and vice versa.

In the absence of equivalence, the FCA will work with EU regulators to try and avoid firms being caught by both the EU and UK DTOs. The FCA believes the right outcome would be for regulators to ensure that where there is a conflict of law, we are clear which rule firms should follow. But this would only work if EU regulators were able to do the same. It would be a suboptimal outcome if the only place firms can execute in a way that complies with their regulatory obligations is outside Europe.

- Data Exchange

The UK Government has legislated to allow the free flow of personal data from the UK to the EU in a no-deal scenario, but without action by EU authorities EU rules would limit the flow of personal data from the EU to the UK. This could restrict EU households and businesses accessing financial services from, and continuing contracts with, UK financial service providers. Given the large range and critical nature of activities, the variety of financial services sectors potentially affected and the scale and importance of cross-border flows of financial services between the UK and EU, the FCA believe there are risks if there is disruption to cross-border flows of personal data from exit day.

As regulators, the FCA also share a lot of data with our European counterparts. Since the introduction of MiFID II in January 2018, the FCA are now passing on around 70% of transaction reports to counterparts across the EU. Data sharing provides both the UK and EU countries with a vital foundation to tackle cross-border market abuse, including insider dealing and cross-market manipulation. We believe it is important for our respective public interest objectives that under all scenarios ways are found to continue this flow of information.

Next steps:

Much progress has been made on preparations in financial services, and this is recognised in the adjustments the Bank of England has made to its scenarios, including its worst case one. Inevitably, the FCA cannot relax, progress is welcome but there are issues still to be resolved and uncertainly to be dealt with.

The FCA will take a pragmatic approach to issues as they arise. The FCA will use forbearance generously but appropriately, to maintain market integrity and protect consumers and market uses. This is what the FCA did around the introduction of MIFID2. The FCA's priority is to do the right thing according to our public interest objectives.

To that end, the FCA will work with firms to make sure their contingency plans are executed effectively. The FCA will continue to engage closely with their EU counterparts and commit to take the necessary joint activity to deal with issues that arise. In the FCA's view, the UK and the EU should be able to find each other equivalent on day one by virtue of having the same legislation and well established supervisory approaches.

So, in short, and to end, the FCA has made considerable progress, but the FCA does not underestimate the task ahead.

Information on SM&CR extension for FCA solo-regulated firms

On 11 September 2019, the FCA published further information for FCA solo-regulated firms relating to the extension of the senior managers and certification regime (SM&CR).

It has updated its webpage on checklists for FCA solo-regulated firms to include additional information relating to Form K, which is the form that firms must submit to the FCA to notify it about which approved persons should be converted to a senior management function (SMF). The information is in the "Enhanced firms" section. The form can be found in Connect, under the "Approved persons" tab.

Form K must be submitted by 11.59 pm on 24 November 2019. A firm's SMFs will appear on the financial services register on 9 December 2019. Therefore, on or shortly after 9 December 2019, the FCA advises firms to check the register to ensure that they have the correct SMFs.

The FCA has also updated its webpage on converting from the approved person's regime to the SM&CR to include a section with information for sole traders. Among other things, it states that sole traders will be limited scope firms and the only SMFs that will normally apply are SMF29 (Limited scope function) and SMF16 (Compliance oversight function).

It goes on to state that the certification regime does not apply to a sole trader as an individual, but may apply to their employees. This means that it does not apply to a sole trader with no employees. In addition, the conduct rules do not apply to a sole trader as an individual unless they hold an SMF. However, the conduct rules will apply to employees of sole traders (unless they perform one of the excluded ancillary roles).

FCA steps up efforts to ensure firms are getting ready for a no-deal Brexit

The FCA is stepping up its efforts to ensure firms are aware of what they need to do to prepare for the potential of a no-deal Brexit. Firms who have not prepared appropriately may risk an impact on their business. To help firms prepare, the FCA will be running a series of digital adverts, and has set up a telephone line (0800 048 4255). This is the most recent phase of the regulator's preparations for a no-deal. The FCA is urging all firms to consider the implications of a no-deal exit and finalise their preparations. This is particularly relevant for firms that:

- are a UK business which does any business in the EEA
- passport into the UK and have not notified the FCA for entry into the Temporary Permissions Regime
- have consumers in the EEA
- transfer personal data from the EEA

Nausicaa Delfas, Executive Director of International at the Financial Conduct Authority, said: '*The FCA has undertaken significant work to prepare for the UK's departure from the EU. We have published extensive information on our Brexit pages and held events, reaching firms and trade organisations around the country. We expect firms to ensure they are ready if there is a no-deal. If firms haven't finalised their preparations, there is a risk they could be impacted. Firms should consult the information on our website*.'

Firms should make themselves aware of any transitional regimes, with deadlines or registration requirements attached to them, which have been put in place by relevant EU Member States. A list is available on the FCA website, but the FCA would draw particular attention to the Luxembourg transitional regime for existing contracts where firms must register by 15 September 2019.

Firms should also consider any regulatory changes that could apply in the event of no deal. For example, MiFID II transaction reporting will change and firms should be ready to implement this. In the event of no-deal **there will be a number of changes to the FCA Handbook**, the Temporary Permissions Regime will come into force, and the FCA will become responsible for Credit Ratings Agencies and Trade Repositories. Firms should take note of these changes in advance.

Firms need to register for Connect to update their firm details

Firms need to register for our online Connect platform. Firms will need it to send firm details - also known as a mandatory annual update. This will be a requirement from January 2020, so the FCA suggests firms register now in preparation. The FCA will be emailing, calling and writing to firms that aren't currently Connect users to encourage them to sign up before the requirement comes into force from January 2020. The FCA will also give firms the information they need to register, such as their firm registration number. From January 2020, firms will be required to review and confirm the accuracy of firm details annually, in line with Accounting Reference Date (ARD). Firms have to do this using Connect.

Even if firm details have not changed from the previous year, firms will still need to log on to Connect and confirm that they are up to date. Connect also allows you to submit applications and notifications, such as approved persons, appointed representatives and MiFID II notifications. You can also track the progress of your applications.

An Individual appears at court for destruction of documents offence

In a prosecution brought by the FCA, an individual has recently appeared at Westminster Magistrates' Court in relation to one count of destroying documents which he/she knew or suspected were or would be relevant to an investigation. The individual pleaded not guilty.

The individual has been granted bail until that hearing. This is the first prosecution by the FCA in relation to a destruction of documents offence under the Financial Services and Markets Act 2000. This individual was under investigation by the FCA for suspected insider dealing offences.

The FCA alleges the individual deleted the WhatsApp application on his mobile phone after he was required to provide it as part of the investigation.

Under section 177(3)(a) of the Financial Services and Markets Act 2000, a person who knows or suspects that an investigation is being or is likely to be conducted under Part XI of the Financial Services and Markets Act 2000 is guilty of an offence if he falsifies, conceals, destroys or otherwise disposes of a document which he knows or suspects is or would be relevant to such an investigation, unless he shows that he had no intention of concealing facts disclosed by the documents from the investigator.

Reporting and Responsibilities under Cayman's New Data Protection Law

The Cayman Islands Data Protection Law, 2017 ("DPL") came into effect on 30th September 2019 and Cayman investment funds will be deemed to be data controllers under the DPL. This applies to all funds, not just those registered with, or otherwise authorised by, the Cayman Islands Monetary Authority.

A key operational consequence of the DPL is that data breaches must be reported to the Office of the Ombudsman in the Cayman Islands within five (5) days. Data breaches can include inadvertent breaches, such as those caused by mis-configured investor data portals, not just malicious intrusions. Failure to notify the Office of the Ombudsman of a breach when required to do so is an offence under the DPL and can result in a conviction and a fine of approximately US$120,000. Failure to notify may also be subject to a monetary fine imposed by the Ombudsman under Section 55 of the DPL.

As the fund is the data controller, it has the reporting and compliance responsibility, but personal data may be stored at various data processors such as the fund administrator, FATCA/CRS consultant, investment manager/adviser and the AML Compliance Officer/MLRO. The Ombudsman recommends that a data controller should have a data protection policy and the absence of such a policy may increase the likelihood of enforcement action in the event of a data breach. Steps you should take:

1. Establish an inventory of personal data processors;
2. Ensure the fund directors are aware of their obligations under the DPL;
3. Ensure the fund board approves a data protection policy that incorporates the eight data protection principles; a. The policy should clearly designate a knowledgeable person who will be responsible for receiving, reviewing any onward reporting data breaches to the Ombudsman;
4. Update agreements with all fund service providers who hold personal data;
5. Update fund documents with a form of privacy notice;

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- Fund authorisation services
- Outsourced MLRO services
- Outsourced compliance solutions
- Regulatory project assistance
  (e.g. Investment Restrictions, Money Laundering, Client Money, ICAAPs)
- Compliance 'Health' checks
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- GDPR assistance
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- Related training
- Financial Crime

UK and Ireland

- Consumer Credit Authorisation, whether you have an interim authorisation or not
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- Fund restructuring services
- ICAAP review and development
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- Fund and firm re-domiciliation advice
- AIFM Authorisation
- AIFM monitoring (including risk services)
- Dublin also provides Fund UCITS IV Reporting, MLRO and Company Secretarial Services.
- Related Training

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