FMConsult compliance solutions

2021 Regulatory Bulletin Issue 2

"Ethics is knowing the difference between what you have a right to do and what is right to do."
- Potter Stewart

The FCA wants to see a healthy financial services industry and firms with cultures that reduce the potential for harm. How a firm prioritises and embeds diversity and inclusion are clear indicators of its culture. Vulnerability of consumers remains a key focus for the FCA, and has been brought into sharp relief by the pandemic.

UK Regulatory News

Why does the FCA care about diversity and inclusion?

In a speech by Georgina Philippou, Senior Adviser to the FCA on the Public Sector Equality Duty, she stated that the FCA want to see a healthy financial services industry with cultures that reduce the potential for harm. How a firm prioritises and embeds diversity and inclusion will be a clear indicator to the FCA of its culture. There is no one size fits all model and the FCA cannot prescribe what any firm's culture should be, but it is the responsibility of everyone in the financial services industry, to create and maintain cultures which embody diversity and inclusion.

It is easy to become overwhelmed by 'culture', it seems far too nebulous a concept to get your arms around. So, it helps to break it down into more manageable components. The FCA uses 4 key drivers, which they consider to be common elements of a healthy culture:

- A meaningful purpose,
- An appropriate governance structure to facilitate good decision making,
- Effective leadership including the tone from the top, and,
- People policies that incentivise behaviours which create an inclusive environment.

FCA finds the Covid-19 pandemic leaves over a quarter of UK adults with low financial resilience.

The FCA has released its latest Financial Lives survey (FLS), looking at consumers' financial situations, the financial products they choose and their experiences of engaging with financial services firms.

According to the October 2020 survey, there are now 27.7 million adults in the UK with characteristics of vulnerability such as poor health, low financial resilience or recent negative life events. Having one of these characteristics means that these consumers are at greater risk of harm. This figure is up 15% since the FCA completed its FLS in February 2020, when 24.0 million displayed characteristics of vulnerability.

Commenting on the findings, Nisha Arora, Director of Consumer and Retail Policy at the FCA said:

'*Vulnerability remains a key focus for the FCA, and has been brought into sharp relief by the pandemic….We expect to finalise our guidance on how firms should treat vulnerable customers shortly.*'

MiFID II: product governance review at FCA

This FCA review looked at Product Governance in a sample of 8 asset management firms. It examined how these firms, as product providers (manufacturers), take MiFID II's product governance rules into account, particularly the interests of the end clients, throughout the product lifecycle.

The FCA's review suggests that some asset managers are not undertaking activities in line with MiFID II's PROD regime.

This increases the risk of investor harm, particularly where investors buy products that may not be appropriate.

The reliance on intermediated services in the UK investment market also means manufacturers commonly rely on those who distribute their products to supply relevant information on the end consumer back to them.

The FCA found that distributors rarely pass this information on to asset managers, hindering firms' ability to effectively meet best practice on product governance. The FCA grouped key observations into 4 main areas: product design, product testing, distributors and governance & oversight:

1. Product design -Of the firms in the review, only 1 manufacturer appeared to have considered the 'negative target market' concept, but it could not identify the specific group of consumers that would be a 'negative target market' for its UCITS and NURS products.

   All firms had a framework for managing conflicts of interest, but not all appeared to be effective. The FCA expects firms to identify, manage and mitigate potential conflicts while providing a service. They should consider whether there are certain product characteristics, such as charges, objectives or its general operation, which could benefit the firm at the expense of the end investor.

2. Product testing - While all manufacturers could provide evidence of some scenario and stress testing, their approaches varied. Differences included how far their analysis considered product-specific characteristics.

   To protect investors, PROD asks certain firms to carry out scenario analysis to assess the risk of poor outcomes to consumers and the circumstances in which they may occur.

   Some cost information shown in marketing documents did not match the information shown in regulatory documents. Most of the firms also appeared to leave out certain charges. The FCA expects manufacturers to disclose costs and charges in a way that is clear, fair and not misleading and that complies with relevant regulatory requirements.

3. Distributors - The quality of due diligence over distributors was variable. Some firms assessed a distributor's arrangements more robustly than others.

   All asset managers faced challenges in getting end-client data from distributors - even when they specifically asked for this information. A recurrent theme was that asset managers feel unable to influence distributors because of the commercial sensitivity of the data request. The asset manager's size was also sometimes described as a factor in this.

   The most problematic area involved pooled nominee accounts for execution-only clients where asset managers rely on distributors for end-investor information.

The systems and procedures for monitoring data internally varied, as did how firms use management information.

4. Governance & oversight - Nearly all firms carried out a formal product assessment or review every year. However, different firms showed varying levels of oversight and challenge across these governance channels.

Key areas the FCA focused on were the second line of defence and product governance committees, the obligations of the authorised fund manager (AFM) board, how firms approached record keeping and training on product governance.

Following these observations, the FCA is likely to undertake further work on this subject. Part of this may be to consider whether they need to make further changes to the product governance rules and guidance for both asset managers/manufacturers and distributors.

FCA launches guidance for firms on the fair treatment of vulnerable customers.

The FCA has published final guidance clarifying its expectations of firms on the fair treatment of vulnerable customers.

The FCA's highlight that the characteristics of vulnerability include poor health, experiencing negative life events, low financial resilience or low capability. Not all people with these characteristics will suffer harm, but they may limit people's ability to make reasonable decisions or put them at greater risk of mis-selling.

Firms should understand what harms their customers are likely to be vulnerable to. Noting these it must ensure that customers in vulnerable circumstances can receive the same fair treatment and outcomes as other customers. The consideration of these needs must happen through the whole customer journey from product design through to customer engagement and communications.

Firms can expect to be asked to demonstrate how their business model, the actions they have taken and their culture ensure the fair treatment of all customers, including vulnerable customers. The FCA has also reminded firms that in treating customers fairly, they should also be aware of their obligations under the Equality Act 2010. It is likely that a breach of the Equality Act, for example failure to provide reasonable adjustments for disabled people, will also be a breach of the FCA's rules.

In addition, the FCA has published a Memorandum of Understanding (MoU) with the Equality and Human Rights Commission (EHRC). This MoU sets out how the FCA will co-operate and work with the EHRC on equalities issues, to help protect people in financial services markets. This MOU will also support the FCA's efforts as it seeks to eliminate discrimination and advance equality of opportunity in line with its obligations under the Public Sector Equality duty.

The FCA will hold firms to account for their treatment of vulnerable customers.

FCA report outlines practices firms can consider to reduce consumer harm caused by failed technology changes.

Financial services technology is constantly updated, but when firms implement changes they don't always go to plan.

This FCA review revealed that failed technology changes are one of the main causes for operational disruption within firms, accounting for a quarter of all high severity incidents that cause harm to consumers and the market.

The FCA found that changes made by firms with strong governance and risk management strategies are more successful, that robust testing is an important part of the change process, and while testing automation has benefits it also presents challenges. It also found that pairing subject matter expertise with a clear understanding of a firm's strategy is vital.

While the coronavirus pandemic has caused some delay to planned technology changes and system updates, it is very important for firms to understand how technology change activity can affect the services they provide, and invest in their resilience to protect themselves, consumers and the markets. This is especially important as firms increasingly use remote and flexible working.

FCA sets out its approach to international firms.

The FCA published its approach to the authorisation and supervision of international firms in which it explains how the FCA will assess international firms when they apply for authorisation to operate in the UK market.

The FCA expects firms seeking authorisation to have an active place of business in the UK to enable the FCA to effectively supervise its UK activities.

International firms serving UK customers can sometimes create different risks of harm compared to UK firms because of the way their businesses are structured and operate. In the approach document the FCA sets out how these risks may be mitigated, and the factors that will be taken into account when deciding whether it may be more appropriate for an international firm to seek authorisation as a UK incorporated firm for all or part of its business.

Funds 'failing' to meet FCA transparency measures - CFA UK report

The investigation found that reports on fund values often did not meet the criteria outlined by the FCA in 2018, with standards varying significantly and many reports on fund value not meeting the spirit of the FCA requirements.

The standard of Assessment of Value (AoV) reports varied substantially according to the findings. For example, a quarter (24%) of AoV reports did not clearly outline their investment objectives, which was one of the few specific requirements outlined by the regulator.

Likewise, 42% failed to state the ongoing charges figure at the individual fund level - one of the most basic features that ought to be available to retail investors.

Additionally, the majority of reports failed to deliver information relating to ESG evaluations, while 62% did not mention risk in any capacity, and 87% refused to outline their liquidity.

Although not required by the FCA, the report argues that they are important considerations that investors should be made aware of, and omission goes against the spirit of the rules.

Burton added: "*The rationale behind making these reports obligatory was to increase transparency about fund performance and value for investors…Many of the reports being published, however, fail to provide the quality and completeness of information needed to advance investor appreciation of their current and potential fund investments.*"

The median percentile score given by the working group to UK reports to articulate their effectiveness was 50%; the scores ranged from 4% to 90%.

CFA UK has outlined recommendations for fund managers, including the clear publication of fund factsheets online, commentary on ESG inclusion, as well as the disclosure of investment objectives.

FCA commences criminal proceedings against brothers for insider dealing and fraud

Following an investigation the FCA has commenced criminal proceedings against two brothers. The proceedings relate to 6 offences of insider dealing and 3 offences of fraud by false representation.

One of the brothers was employed as an analyst at a leading global investment bank in the Conflicts Resolution Group of their London office. The other brother was a solicitor, also in London. The alleged offending took place between 15 July 2016 and 4 December 2017 and involved trading in 6 stocks. The total profit from the alleged insider dealing was approximately £142,000.

The fraud charges relate to 3 personal loans obtained, totalling £95,000. The loans were stated to be for funding home improvements. Instead, the loans funded the alleged insider dealing.

Fraud is punishable by a fine and/or up to 10 years' imprisonment. Insider dealing is punishable by a fine and/or up to 7 years' imprisonment.

FCA launches High Court proceedings against two individuals

As part of these proceedings, an interim injunction has been secured which freezes the assets of Individual 1 and his partner, Individual 2, up to the value of £7 million, pending a further hearing. The FCA alleges that:

- The Firm that Individual 1 was director and co-owner of has contravened various requirements under the Financial Services and Markets Act 2000 by providing unsuitable defined benefit pension transfer advice, leading consumers to exit defined benefit pension schemes when it was not in their best interests to do so;
- Individual 1 was knowingly concerned in those contraventions.

It will also be alleged that Individual 1 breached FCA requirements by undertaking a course of conduct which resulted in the removal of his Firm's assets, leaving it unable to meet potential liabilities for unsuitable advice, whilst enabling Individual 1 to retain the significant profits that accrued from the provision of that advice, and from ongoing fees.

An injunction was obtained against Individual 2 as she may be holding or controlling assets owned by Individual 2.

The FCA is asking the Court to make a restitution order requiring Individual 1 to compensate consumers who have suffered losses as a result of receiving unsuitable pension transfer advice. No trial date has been set.

FCA secures interim restitution order against illegal deposit takers

The FCA has secured an interim restitution order of just over £676,000 against 5 of the 7 defendants accused of carrying on unauthorised deposit taking by accepting money for projects including forex-trading and crypto-assets without FCA authorisation.

The court ordered that a Firm and 3 of the defendants were jointly and severally liable for repaying money to members of the public who invested. A further defendant (another firm), had its liability capped at just over £137,000 to reflect the short time it was involved in the unauthorised activity.

The court also made declarations that the fundraising involved unauthorised deposit-taking and ordered permanent injunctions against the 5 defendants.

The proceedings continue against 2 defendants, who oppose the FCA's claims. The proceedings will continue with a trial on a date to be confirmed. In the meantime, injunctions freezing the defendants' assets up to £1.3 million are in place.

Mark Steward, Executive Director of Enforcement and Market Oversight at the FCA said: '*This restitution order means we can take steps to repay some of the money to investors before the full case is heard by the court. The FCA will continue to pursue the case against the two remaining defendants and will seek to recover as much of the balance as possible.*'

Irish Regulatory News

COVID-19 shows that we need to think afresh about how we govern and manage risk – Deputy Governor, Ed Sibley

Speaking at a virtual webinar at the Institute of Directors webinar, Deputy Governor, Ed Sibley, outlined the implications of uncertainty on how organisations are governed, led and managed and how the approach to governance and risk management needs to be improved.

COVID-19 has increased focus on the levels of preparedness and thinking on emerging risks such as climate change and technological innovation. Lessons need to be learned from the pandemic on how organisations and leaders think about and manage risk and apply the recent learnings to future challenges. Improvements are required in how regulated firms are being governed and how they recognise and manage risk.

Deputy Governor Sibley spoke about the Central Bank's strategic priorities in financial regulation in 2021, which include:

- maintaining supervisory focus on financial and operational resilience of firms and markets to ensure they continue to support households and business through the economic disruption caused by COVID-19;
- focusing on strong governance and risk management capabilities in firms and markets to improve culture and decision-making and ensure that risks are identified and effectively mitigated,
- seeking to ensure that detrimental consumer outcomes are identified, prevented or mitigated, such as business interruption insurance, where extensive supervisory engagement continues to ensure firms pay valid claims

- resolving both pandemic related and longer term distressed debt in the system.

"We cannot anticipate every type of shock but we can build resilience" – Speech by Governor Gabriel Makhlouf

Speaking at the European Financial Forum Governor of the Central Bank of Ireland (CBI) Gabriel Makhlouf provided an overview of the outlook for the macro-financial environment and an outline of the CBI's priorities for the year ahead.

Governor Makhlouf said that "*For authorities, now is not the time to unwind either fiscal or monetary support. And for the financial sector, as it moves from absorbing the shock to supporting the recovery, a key focus must be on managing risk, while rebuilding resilience.*"

Governor Makhlouf set out some of the priorities for the CBI in 2021 in the areas of monetary policy, macroprudential policy, the impact of COVID-19 on the financial system and consumers, building resilience into financial system against future shocks, markets based finance, digital transformation and climate change.

The Governor concluded by saying that a key priority for the CBI "*is to engage with the public and stakeholders across the whole economy, in particular to listen and learn. Better engagement helps us understand the issues faced by the businesses and households in the economy, the opportunities to enhance the performance of the financial system, and any risks that may be developing.*"

CBI - Securities Markets Risk Outlook Report 2021

The CBI has published its first Securities Markets Risk Outlook Report. The Report identifies key conduct risks to securities markets in the coming year. The Report also outlines the CBI's supervisory priorities for securities markets in 2021.

It identifies a number of key areas that the CBI expects firms to address including:

- **Impact of external shocks**: firms are expected to stress-test their operations and plan for shocks, including those arising from COVID-19 and Brexit, based on plausible worst-case scenarios.
- **The migration to a greener securities market**: by financing initiatives and trends aimed at stemming the climate crisis, sustainable finance can play a key role in ensuring that securities markets aid a successful transition to greener economic activities.
- **Increasing complexity**: firms must take appropriate steps to manage the increasing complexity and fragmentation in securities markets.
- **Ensuring meaningful transparency**: it is essential that investors & market participants can make informed decisions using available information & reliable pricing.
- **Increased use of indices**: firms must ensure they understand the risks and implications and be transparent with the market on their use.
- **Misconduct risk**: must be identifies, mitigated and managed, particularly the risk of market abuse.
- **Governance arrangements**: must be fit for purpose and properly resourced, even as businesses expand/change.
- **Data quality**: firms must take steps to improve the quality of the data used and reported to the CBI.

The CBI has planned a number of work items that relate specifically to the risk outlook published in the Report.

CBI supports common Eurosystem stance for climate change-related sustainable investments in non-monetary policy portfolios.

The CBI welcomes the announcement from the European Central Bank agreeing a common stance for climate change-related sustainable and responsible investment principles for euro-denominated non-monetary policy portfolios (NMPPs) for Eurosystem central banks. The CBI is already working to align itself with this approach in collaboration with our Eurosystem colleagues.

Climate change is already having, and is expected to continue to have, a profound effect on our planet, societies and economies. The transition to a low-carbon economy constitutes major structural change, with significant implications for the economy and the financial system and will require significant adjustments by households, businesses and policymakers globally.

The CBI has been increasing its own focus in this area in recent years. It has established a dedicated Climate Change Unit and also joined the Network for Greening the Financial System, a group of central banks and supervisors that share experiences and best practices to contribute to the development of climate risk management in the financial sector.

The CBI is active in a number of supervisory fora that are considering the impact of climate change on different parts of the financial sector.

Heading Enforcement Action Notice: Insurance Firm reprimanded and fined €41,385 by the CBI for breaches of the Consumer Protection Code 2012

The CBI's investigation found that the Insurance Firm failed to comply with the Code in respect of having adequate systems and controls to allow it to correctly apply fees in accordance with its Terms of Business, and communicate clearly on fees to its customers in order for them to make informed financial decisions.

62 customers were overcharged a total of €9,964.36 over a five year period. These customers have been fully reimbursed by the Insurance Firm. Out of 265 invoices reviewed, the CBI found that communication of applicable fees in 190 cases was unclear, in that the firm failed to bring fees to the attention of the customers. This resulted in the customers not being fully aware of the fees being charged.

The breaches in this matter were not self-reported by the Insurance Firm, and would have continued if it had not been for the CBI's identification of the breaches as part of an inspection in June 2017.

During the course of the investigation, the Insurance Firm provided the CBI with incomplete and unclear responses to requests for information which led to delays in the investigation. The CBI considered this to be an aggravating factor in the case.

The CBI determined the appropriate fine to be €59,121, which was reduced by 30% to €41,385.

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UK and Ireland

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- Fund and firm re-domiciliation advice
- AIFM Authorisation
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- Dublin also provides Fund UCITS IV Reporting, MLRO and Company Secretarial Services.
- Related Training

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