FMConsult compliance solutions

2019 Regulatory Bulletin Issue 6

> ***"I want to start with what I intend as an unambiguous statement; namely that the culture of firms and the people that make them up – and of course therefore the culture of industries insofar as it can be generalised – is of the utmost importance to financial regulators"***
>
> ***Andrew Bailey, 9th May 2016***

In a month full of headlines regarding a star Fund Manager, the prosecution of a Compliance officer for insider trading, and the successful prosecution of a firm for failing to fight fraud it is not clear that firm's sufficiently heeded the Regulators warning for a need for culture change.

FCA "Dear CEO" letter to Wealth Managers and Stockbroking firms

The Financial Conduct Authority ("FCA") sent out a Dear CEO letter setting out a list of areas where wealth managers can cause their clients potential harm. These wealth managers should assess whether their business poses a risk to clients and consider strategies to mitigate those risks.

The FCA identified four ways firms can harm clients:

- Reduced levels of savings and investments due to fraud, investment scams and inadequate client money, or assets controls
- A loss of confidence in the industry's ability to deliver their financial objectives due to mismanagement of conflicts of interest and market abuse
- Reduced levels of savings and investments due to order handling procedures and execution processes that do not deliver best outcomes
- Inability to understand the costs of services provided by firms, due to insufficient or inaccurate disclosure of costs and charges

The FCA also set out where it saw its regulatory priorities:

Suitability - client portfolios must be aligned and managed to the risk profile of the client. High risk investments must not be inappropriately included in clients portfolios.

Fraud - this as a 'priority' area for the FCA, who said it would use a range of data to identify the 'small' number of firms which are cause for concern. Many of the firms the FCA have already taken action against have used their clients' portfolios in investment scams or other highly unsuitable investments or to conduct market abuses.'

Best Execution - The FCA also wants to see evidence that firms are endeavouring to obtain the best possible result for their clients when executing client orders or passing them to other firms for execution. The Investment Platforms Market Study, 'highlighted specific issues and weaknesses in platform service provider firms' order handling procedures and best execution evaluations'. The FCA expects firms to have effective day-to-day executions processes, contingent arrangements for periods of market distress and clear, comprehensive and effective oversight and monitoring arrangements.

Costs and charges disclosure - the FCA has looked at MiFID II ex-ante costs and charges disclosures of a sample of 50 firms in the retail investments sector and found flaws in the system, with firms interpreting the rules in a wide variety of ways. The FCA noted that while firms were generally better at disclosing the costs of their own services, they were not so great at disclosing relevant third-party costs and charges. The FCA said it may conduct further work to assess how firms are implementing ex-post costs and charges disclosure.

The FCA has reminded firms that all communications to customers about their MiFID business must be fair, clear and not misleading.

EU withdrawal - Where EU withdrawal may impact customer relationships (e.g. for customers based in the EEA) the FCA expect firms to act in their customers' best interests and maintain clear communication throughout.
If you have any customers in the EEA, you must decide on your approach to servicing your existing contracts with them. You should take steps available to you to continue to service customers in accordance with local law and national regulators' expectations.

Thematic AML Review findings

In June the FCA set out its assessment of the money laundering risks and vulnerabilities in the capital markets. The FCA reminds firms and individuals that enforcement in this area is a priority which is particularly important as in the report the FCA identifies some areas in which it has found a lack of awareness of risks and provides firms with clear reminders of their obligations.

Its review of 19 firms that that firms are not as aware of the risks of money laundering as they are of the risks of market abuse and that many firms have not addressed the potential linkages between the two.

Training was also not seen to be sufficiently tailored or comprehensive, particularly regarding when and how AML issues arise, how to respond and submitting Suspicious Activity Reports ("SARs").

There were some short comings in customer due diligence ("CDD"), especially the identification of ultimate Beneficial Owners.

Firms should take careful note of the guidance provided the FCA assessment and ensure that their systems and controls reflect them. Any subsequent review by the FCA of a firm's systems and controls will factor in this advice and enforcement will factor in a firm's response to the guidance when taking action. FMConsult can assist firms assess its compliance against these requirements.

FCA Report on the boundaries of regulated activity

In June the FCA has published its first annual perimeter report. Andrew Bailey, CEO of the FCA commented that the perimeter "*is tested by the actions of particular firms and how those actions can harm consumers, for instance by firms innovating and creating new product offerings and services and by firms deliberately trying to avoid our perimeter.*"

Boundary issues noted include:

- Investment consultants advising pension fund trustees on matters such as asset manager selection are currently outside regulated activity. However, the FCA identified serious competition concerns with investment consultancy and fiduciary management in its Asset Management Market Study and the Treasury therefore plans to consult on bringing these services within the perimeter.

Unregulated firms that contact consumers with offers of free pension reviews. These can be instrumental in consumers deciding to transfer out of defined benefit pensions, potentially losing valuable benefits. This is activity is not currently treated as regulated advice and the FCA reminded firms offering "investment advice" in this context must be regulated.

- Tech companies are continuing to be monitored by the FCA noting that: "*the boundary between providing mostly unregulated technical infrastructure to deliver financial services and providing regulated activities is increasingly narrowing. This also raises questions around whether financial regulators have the necessary tools and techniques to effectively oversee those organisations.*"

- The Treasury will consult on its approach to cryptoassets that currently fall outside the perimeter "later" this year. The FCA has said that it will consult on a potential ban on retail sales of products (for example, derivatives) that reference unregulated cryptoassets stating: "*Cryptoassets can display different characteristics through their life and be used for different functions, which can create uncertainty as to which cryptoassets already fall within the perimeter.*"

- The FCA acknowledges that the perimeter is a patchwork of UK and EU legislation; and that this can create confusion. Andrew Bailey, CEO of the FCA, states, "*We may have an opportunity to create a simpler approach **post-Brexit**. This year we have started to consider the future of regulation to help determine the UK financial services framework after Brexit.*"

FATF to release new rules for global crypto sector

On June 21, the Financial Action Task Force (FATF) is expected to publish a note clarifying how G7 nations should exercise oversight for the digital assets sector. The new rules will apply to crypto exchanges, custodians and crypto hedge funds, among others. FATF is an intergovernmental organization to promote the implementation of legal, regulatory and operational measures to fight money laundering. Bloomberg reports that the FATF rules are expected to require firms ranging from major spot exchanges to asset managers to gather data on all clients initiating transactions worth over $1,000 or 1,000 euros.

They will also be asked to provide data on the recipients on the funds, and share that data with the recipient's own service provider together with data on each transaction, Bloomberg claims. The forthcoming rules will notably be subject to the interpretation of different national regulators.

Some industry participants have reportedly voiced concerns that **blockchain technology would have to be fundamentally restructured** — or otherwise a complex parallel system constructed between exchanges — in order to satisfy new reporting requirements, while others are concerned about the toll that increased compliance costs will exact on industry businesses.

New FCA rules for Crowdfunding P2P platforms

On 4th June 2019 the FCA published final rules for peer-to-peer lending platforms. The FCA stated that the new rules are designed to help better protect investors and allow firms and fundraisers to operate in a long-term, sustainable manner. The new rules and guidance will primarily **come into force on 9th December 2019**.

The final rules contain guidance on the topics that P2P platforms should consider including in the appropriateness assessment, including:

- the nature of the client's contractual relationship with the borrower, and with the platform;
- the client's exposure to the credit risk of the borrower;
- that all capital is at risk
- the fact that investments on the platform are not covered by the Financial Services Compensation Scheme;
- that returns may vary over time;
- that entering into P2P agreements or investing in a P2P portfolio is not comparable to depositing money in a savings account;
- information on the platform's risk mitigation measures, including in the event of its insolvency; and
- the role of the platform and the scope of its services.

Overall, the FCA believes that the new rules strike an appropriate balance as they should allow the P2P sector to continue to market to new investors and to differentiate themselves, while also protecting investors.

Firms can expect the FCA to be monitoring compliance carefully, especially following the Dear CEO letter it published for P2P platforms in March this year.

European Banking Authority (EBA) published its Final Report on the draft Guidelines on outsourcing arrangements.

The guidelines are relevant to UK banks, societies, designated investment firms and IFRU investment firms. The guidelines will come into force on 30 September 2019.

The guidelines run through a series of items firms must consider when outsourcing including:

1. Proportionality;
2. Assessment of outsourcing arrangements;
3. Governance Framework; and
4. The process for outsourcing

The guidance on the process sets out 8 areas for firms to focus on:

1. Pre-outsourcing analysis;
2. Risk Assessment of outsourcing arrangements;
3. Contractual phase;
4. Security of Data and Systems;
5. Access, information and audit rights;
6. Termination rights;
7. Oversight of outsourced functions; and
8. Exit strategies

FMConsult can provide further details of this guidance upon request.

Regulatory co-operation between the UK and US: now and in the future

The FCA itself is a strong advocate for successful, open, global financial markets, with regulation that underpins free trade, pointing away from tying markets to locations. In the UK, the FCA work on preparing for Brexit has reiterated the importance of regulatory co-operation, as a means of ensuring not only effective oversight, but also market access.

Where markets are cross-border, the FCA co-operates to ensure frameworks are consistent in terms of outcomes, and that opportunities for regulatory arbitrage are minimised. Where markets are more local, they share best practice and promote common approaches wherever appropriate.

The FCA stated that whilst Brexit will create challenges, London will remain an important international centre and a hub for global firms; whatever the outcome, firms can expect the FCA to continue to champion high standards, international coherence and open markets. They commit to continuing to build on our strong relationships with both US and EU regulators.

FCA fines leading Scottish bank for failing to report suspicions of fraud at Reading Branch.

The FCA has today fined a leading Scottish Bank £45.5m for failures to disclose information about its suspicions that fraud may have occurred at the Reading-based Impaired Assets (IAR) team. The FCA found that the bank failed to be open and cooperative and failed to disclose information appropriately to the then regulator, the Financial Services Authority (FSA).

Mark Steward, Executive Director of Enforcement and Market Oversight at the FCA, said: "*The bank 'failed to alert the regulator and the police about suspicions of fraud at its Reading branch when those suspicions first became apparent. The Scottish bank's failures caused delays to the investigations by both the FCA and Thames Valley Police. There is no evidence anyone properly addressed their mind to this matter or its consequences. The result risked substantial prejudice to the interests of justice, delaying scrutiny of the fraud by regulators, the start of criminal proceedings as well as the payment of compensation to customers.*'

The Director of the Impaired Asset Team at a branch had been sanctioning limits and additional lending facilities beyond the scope of their authority undetected for at least three years. The bank knew by 3 May 2007 that the impact of these breaches would result in substantial losses. If the bank had communicated its suspicions to the FSA in May 2007, as it should have done, the criminal misconduct could have been identified much earlier. The delay also risked prejudice to the criminal investigation conducted by Thames Valley Police.

The leading Scottish bank agreed to resolve the matter and qualified for a 30% (stage 1) discount. Were it not for this discount the FCA would have imposed a financial penalty of £65m. The FCA also **banned four individuals** from working in financial services due to their role in the fraud.

22-year-old gets 2 years in jail and must forfeit $823,357 for illegally selling hundreds of thousands in Bitcoin

A 22-year-old man in the US has been sentenced to two years in prison and must forfeit $823,357 in illicit profits for selling hundreds of thousands of dollars in Bitcoin BTC through an unlicensed money transmitting business. He plead guilty, admitting he had operated a Bitcoin exchange without previously registering the business with the Financial Crimes Enforcement Network (FinCen) of the US Department of Treasury.

He also admitted he had not implemented the necessary anti-money laundering procedures (AML). The man advertised his business on LocalBitcoins.com and communicated with customers using text messages and emails, typically resorting to encrypted applications. He negotiated a commission of 5 percent above the prevailing exchange rate, and accepted cash payments in person, through ATMs, and MoneyGram.

The 22-year-old also admitted he failed to have a "Know Your Customer" program and said he did not perform any due diligence on the source of his client's funds. At first, the man bought his initial supply of Bitcoin using a US-based regulated exchange, but his account was eventually closed due to the suspiciously large trading volume.

Two found guilty of insider dealing

A former UBS compliance officer and her trader friend have been found guilty of insider trading. Both were convicted of three offences of insider dealing and sentenced to 3 years' imprisonment. Another person was found to have passed along tips on deals to the trader friend gained through her role in the compliance team of a London office, where she worked for more than a decade. The FCA alleged he used this information to earn £1.4 million in profit between 2013 and 2014 through trading contracts for difference. While the person who passed the tips was not found to have received any of the proceeds, she benefited from the trader friend's favour, which included time spent at an exclusive Mayfair nightclub, of which he was said to be a high-rolling member.

Over the course of the indictment period, the two traders sought to conceal their criminal activity by using unregistered pay-as-you-go mobile phones, changing and swapping SIM cards at regular intervals, to communicate with one another. When interviewed after her arrest one of the defendants lied to the FCA and denied using unregistered mobile phones. The other declined to answer questions in interview.

Mark Steward, Executive Director of Enforcement and Market Oversight at the FCA, said. One of the defendants '*dishonestly and surreptitiously acquired confidential and valuable information from her employer and passed it to [other defendant] who made substantial illegal trading profits. Both defendants were well aware they were committing serious criminal offences and engaged in elaborate schemes and lies to disguise what they were doing. This was not opportunistic, but calculated and organised. It was insider dealing at its most venal. The FCA is determined to attack all forms of insider dealing, from opportunistic insiders to those who devise dishonest schemes to exploit and manipulate sources of inside information.*'

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FMConsult Services

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

UK and Ireland

- Consumer Credit Authorisation, whether you have an interim authorisation or not
- Investment & Operational Risk management services
- Fund restructuring services
- ICAAP review and development
- ACD / Management Company structuring and governance review
- 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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