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18 May 2022

Financial Regulation Monthly Breakfast Seminar

Overview

- Financial crime controls: findings from FCA's review
- Market Watch 69 – MAR Surveillance
- Diversity and inclusion on company boards and executive management: FCA's new requirements
- Consumer credit: FCA's Dear CEO financial promotions warning
- ESG: new Regulatory Technical Standards for SFDR

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Financial crime controls: findings from FCA's review

Jonathan Ritson-Candler

FCA identifies financial crime controls issues at challenger banks

- FCA has published findings of a review of the financial crime controls in place at 6 “challenger banks” representing approximately 8 million UK customers
- Reason for this focus is that these banks “depend on rapid customer growth for survival” and therefore offer “a quick and easy application process”
    - Concern that this could come at the “detriment of complying with customer due diligence (CDD) obligations”

FCA identifies financial crime controls issues at challenger banks

- Review supports the FCA’s “strategy to publicise the findings of [its] financial crime assessments to raise awareness of financial crime risks among the financial industry”
- Despite focus being on the retail banking sector, FCA’s observations of good and poor practice are generally applicable and a helpful reminder of the regulator’s emphasis on AML and CTF systems and controls

Good practices identified

- Effective and innovative methods of CDD data collection and use to identify and mitigate risks
  - For example, non-traditional approaches to identification and verification - video calls with clients, mobile phone geolocation data, taking snapshots of a person's passport alone and with the customer in shot
- Evidence that firms prepare and maintain stand-alone financial crime policies and procedures that are regularly updated and tailored to the firm
- Incorporation of additional fraud monitoring for known fraud typologies at client onboarding
  - For example, Credit Industry Fraud Avoidance Scheme checking, as well as checks on customers that use multiple devices to manage their accounts
- Despite this, the FCA noted that "much more needs to be done overall" to ensure firms are identifying and managing financial crime risk

Areas for improvement

- **Customer Risk Assessments (CRA)**
  - Not well developed and lacked detail
  - Essential to ensure that the risks to the firm of a customer relationship are captured
  - Without a CRA, a firm cannot ensure CDD and ongoing monitoring are effective and proportionate to the risks posed by individual customers (no “one size fits all” approach)
  - CRA must be updated if a firm’s business model and/or product offering changes

Areas for improvement

- **CDD**
  - Most firms were not capturing more than basic CDD information (identification and verification) e.g., income and occupation information was not being collected to inform the CRA (impacts the effectiveness of ongoing transaction monitoring)
  - Firms must gather sufficient information to assess the purpose and nature of the customer’s relationship with them, in turn, forming a complete picture of the risks associated with the customer
  - Must be able to identify higher risk customers at onboarding (do not rely on transaction monitoring)
- **Enhanced due diligence**
  - Must be applied consistently and documented in a formal procedure
  - Do not limit to PEPs

Areas for improvement

- **Financial crime change programme**
  - Firms experiencing rapid growth and/or changes to their operating model must have a clearly documented programme in place for updating financial crime systems and controls, including setting key milestones, delivery dates and ensuring senior managers are accountable
  - Risk Committee, Audit Committee and CEO should be involved in overseeing such projects
- **Ineffective transaction monitoring and alert management**
  - Inconsistent and inadequate rationale for discounting transaction alerts and poor record keeping
  - Inadequate resources to review alerts in a timely manner
  - Impacts ability to file SARs as soon as practicable

Areas for improvement

- **Submission of suspicious activity reports (SARs)**
  - Substantial increase in the volume of SARs and Defence Against Money Laundering (DAML) reports submitted, in particular by challenger banks
  - Often for very low amounts that are less likely to result in law enforcement action
  - FCA views this as indicative of inadequate client onboarding and CDD processes to identify clients outside a firm’s risk appetite
  - Also notes that where reports are made but appropriate blocks are not in place meaning the customer can continue to transact
  - Quality of SARs is poor (e.g., including a lot of transactional data but not explaining why this is suspicious or which otherwise are not specific enough about what gave rise to the suspicion of money laundering / terrorist financing)

Areas for improvement

- **Principle 11 notifications**
  - In the event of either a breach of, or the identification of material gaps in compliance with, financial crime obligations, the FCA reminds firms to consider their Principle 11 notification obligation

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Market Watch 69 – MAR Surveillance
Rob Moulton

Market Watch 69 – MAR Surveillance (1)

- Market abuse risk assessments
  - Consider different types of market abuse, and different markets, and calibrate accordingly
  - Then vary the risk assessment between different types of trading (advised v execution-only, electronic v voice etc.)
  - Consider links to other risks such as AML / credit
- Order and trade surveillance
  - Calibrate by asset class, rather than common thresholds
  - Avoid simply using pre-set parameters
  - Insider dealing look back should be more than 24 hours
  - Include cancelled and amended orders

Market Watch 69 – MAR Surveillance (2)

- Monitoring policies and procedures
  - Needs detailed examples of type of abuse to look for
  - Must take a consistent approach across employees (training?)
  - Front office involvement can help but should be limited
- Outsourcing
  - Needs a close relationship to avoid impact of limited understanding by third party of business, risk appetite
  - When provided cross-border impact of lack of MAR knowledge (e.g. group surveillance)
- PA dealing
  - High focus area for FCA
  - Disciplinary process does not delay principle 11 notification obligations

Diversity and inclusion on company boards and executive management: FCA's new requirements

Nicola Higgs

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **20 April 2022**: FCA published final rules (PS22/3) revising the UK Listing Rules and Disclosure Guidance and Transparency Rules (DTRs) to improve transparency on the diversity of boards of directors and executive management of UK listed issuers
- Require premium and standard listed companies to make diversity-related disclosures (gender and ethnic diversity) at board and executive level for financial years starting on or after 1 April 2022. Therefore, the first reporting will start to appear in reports around 2023

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **Diversity and inclusion targets**: Listing Rule revisions will be made (Chapters 9 and 14) to introduce annual ‘comply or explain’ reporting regime with respect to board-level diversity targets. These will require companies to confirm whether they have met the specified targets as at a reference date chosen by it in the financial year:
  - At least 40% of the board are women
  - At least one of the senior board positions is held by a woman (Chair, CEO, Senior Independent Director, or CFO)
  - At least one member of the board is from a minority ethnic background (defined by reference to categories recommended by the Office for National Statistics (ONS), excluding those the ONS lists as coming from a White ethnic background)
- Where an issuer has not met one or more of these targets, it must disclose that fact and explain the reasons why

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **Numerical data**: Issuers will need to disclose numerical data on the sex or gender identity and ethnic diversity of their board, senior board positions, and executive management in a standardised table (with issuers able to add to the fields “men” and “women” to include “non-binary” or other gender identities)
  - There is also a specific exemption from reporting where board members or management are situated overseas and local laws in the relevant jurisdiction prevent the collection or publication of such data
  - Guidance is provided for UK listed issuer that wishes to include further information in its annual financial reports to provide context (e.g. a brief summary of key policies, procedures and processes, or any mitigating factors making diversity a challenge)

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **DTR amendments**: Disclosures of a company's diversity policy under DTR 7.2.8AR will be expanded.
  - Disclose in the corporate governance statement the diversity policy applied to their board, or explain where no such diversity policy is applied
  - The description will cover factors such as ethnicity, sexual orientation, disability and socio-economic background, as well as the existing factors (e.g. age and gender). Also, companies will need to disclose how their diversity policy is applied to their key board committees (remuneration, audit and nomination)

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **Voluntary early disclosure**: FCA is encouraging companies whose financial years began before 1 April 2022 (from 1 January 2022) to consider including these disclosures in their annual report on a voluntary basis ahead of 2023. It is possible for companies to start putting the processes in place to collect and report sooner because they are able to choose their own reference date against which to make these disclosures

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- **Possible future expansion:**
  - The FCA intends to review the impact of these targets in three years' time and it has indicated that this may lead to a revision of the nature or level of these targets, and possibly include targets on other aspects of diversity
  - Diversity and inclusion are being considered under a joint FCA, PRA and BoE project and a consultation paper is expected in 2022. This will likely lead to requirements applying across the financial services sector that will be relevant for firms authorised by the FCA which are also listed

FCA PS 22/3: Diversity and inclusion on company boards and executive management

- In a speech delivered on 5 May 2022, the FCA's Chief Executive, Nikhil Rathi, stated that:
  - *"Firms that do not embrace diversity of thought will struggle to serve the needs of a diverse customer base and manage* ***conduct risk*** *effectively"*

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Consumer credit: FCA's Dear CEO financial promotions warning

Ella McGinn

Consumer Credit: Dear CEO Letter

- FCA issued a Dear CEO warning letter addressed to **credit brokers** and **firms providing high-cost lending products**
- FCA concerns relate to financial promotions inviting or inducing customers to take out high-cost credit
- All such communications must be clear, fair and not misleading and comply with the rules of CONC 3
- Customers must understand the nature of a firm's regulated activities

Consumer Credit: Dear CEO Letter (cont.)

- Cost of living crisis likely to lead to greater demand for credit
- Focus on those who are particularly vulnerable to suffering harm as a result of such lending
- FCA has made clear it is keeping the sector under proactive and close review to prevent **unsustainable and unaffordable lending**
- FCA has stressed the importance of having a healthy culture that promotes fair outcomes for customers

Consumer Credit: Dear CEO Letter (cont.)

- FCA has identified a number of potential problem areas in promotions:
  - Promotions using phrases such as “no credit check loans”, “loan guaranteed”, “pre-approved” or “no credit checks”
  - A statement / implication that credit is guaranteed or pre-approved or is not subject to credit checks or affordability assessment may breach CONC 3.3.3R:
    - “*A firm must not in a financial promotion or a communication to a customer state or imply that credit is available regardless of the customer's financial circumstances or status*”
  - Failure to include mandated high-cost short-term credit risk warning in promotions for both broker services and direct lending in breach of CONC 3.4.1R:
    - “*Warning: Late repayment can cause you serious money problems. For help go to moneyhelper.org.uk*”
  - Failure to include Representative APR where required
  - Failure by credit brokers to state that they are brokers not lenders (CONC 3.7.7R)

Consumer Credit: Dear CEO Letter (cont.)

- FCA reminds firms of separate obligations under UK Code of Non-broadcast Advertising and Direct & Promotional Marketing (CAP Code) administered by the Advertising Standards Authority (ASA)
- ASA has stated that:
  - "*because short-term loans are often aimed at potentially vulnerable consumers, marketers should be particularly careful to ensure that marketing for high-interest, short-term loans is socially responsible. When assessing ads, the ASA is likely to consider issues such as the undue emphasis on speed and ease of access, the targeting of vulnerable groups and whether the ad could be seen to trivialise taking out a loan*"

Consumer Credit: Dear CEO Letter (cont.)

- Relevant firms should:
  - Review current financial promotions to ensure they are CONC 3 compliant
  - Review process and systems and controls for financial promotions to ensure they are sufficiently robust to meet regulatory requirements and expectations, including oversight of any appointed representatives
  - Discuss the FCA’s letter with the Board to ensure they are cognizant of and have considered the issues raised and approved any actions taken in response
- FCA recommends records be kept of the above included evidence of actions taking place and outcomes of subsequent actions
- FCA has the power to withdraw and prevent use of non-compliant adverts

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ESG: new Regulatory Technical Standards for SFDR
Anne Mainwaring

SFDR and final RTS structure

- On 6 April 2022, the European Commission published the final Delegated Regulation supplementing the SFDR
- Annexes published with the draft Delegated Regulation:
    - Annex 1: Template principal adverse sustainability impacts statement
    - Annex 2: Template pre-contractual disclosure for specified financial products (Article 8 Products / and Article 6 Taxonomy)
    - Annex 3: Template pre-contractual disclosure for specified financial products (Article 9 Products / and Article 5 Taxonomy)
    - Annex 4: Template periodic disclosure for Article 8 financial products
    - Annex 5: Template periodic disclosure for Article 9 financial products

Overview

- **Small changes and clarifications**: various recitals and RTS text have been changed for clarification purposes but the same basic disclosure approach to previous versions appears to be adopted. This applies to the PAI indicators and metrics (the Annex 1 template for principal adverse sustainability impacts statement contains the same formulae). Examples:
  - New sub-sections have improved the clarity as between disclosure requirements for FMPs and financial advisers
  - the hazardous waste indicator under Annex 1 now expressly includes the radioactive waste ratio (meaning an amendment in scope)
  - Under website disclosure (Article 25), the translation requirement for the summary section depends upon where the product is “made available” in a host Member State (as opposed to where it is marketed)

PAI indicators (or PAIs)

- **‘Planned’ actions and targets**: for each PAI indicator a firm within scope now also needs to “describe” not only the actions taken during the relevant period, but “the actions planned or targets set for the subsequent period from 1 January to 31 December to avoid or reduce the principal adverse impacts identified”. (Article 6(2))
- **Standards required for collection of data** (compliance with SFDR Art 4): PAI indicator data collection by FMPs from all available sources demands “best efforts”. (RTS Art 7(2))
    - When PAI indicator data is not “readily available”? FMPs must include details of the best efforts used to obtain the information directly from investee companies, through additional research or via third party data providers/external experts “or making reasonable assumptions”

Article 8 and 9 and taxonomy alignment

- Disclosures on the extent to which a product is Taxonomy aligned:
  - Appears that ‘Article 8 light’ funds do not have to be Taxonomy aligned
  - ‘Article 8+’ products that commit to make sustainable investments / Article 9 products) - **required**, where they make one or more environmentally focused sustainable investments
  - Even where these products do not wish to consider the Taxonomy, it seems that zero Taxonomy alignment will need to be disclosed

ESAs questions to the Commission on the interpretation of SFDR and Taxonomy

- **Question 10**: In case a financial product referred to in Article 8 SFDR which promotes environmental characteristics does not commit in the pre-contractual disclosures to invest in any economic activities that contribute to an environmental objective within the meaning of point (17) of Article 2 SFDR, is the financial market participant obliged to disclose the information required by Article 6 TR? If it is determined later that the same financial product in fact invested in such economic activities, is the financial market participant obliged to make that disclosure?

- Similarly, in case a financial product referred to in Article 9 SFDR only committed in the pre-contractual disclosures to invest in economic activities contributing to social objectives and if it is determined later that the financial product in fact invested in economic activities contributing to an environmental objective, would the financial market participant be obliged to disclose the information required by Article 5 TR?

MiFID II suitability requirements - SMSG advice

- In recent advice from the Securities and Markets Stakeholder Group (SMSG) to the ESMA consultation on guidelines on certain aspects of MiFID II suitability requirements, some interesting points were made:
  - <u>Shifting the burden to the investor</u>
    - *"…the philosophy of confronting the client with a high number of indicators shifts the burden of interpretation towards the investor. Due to the highly quantitative approach, there is a risk that the potential role of engagement is disregarded and that the focus is on mere exclusion criteria and minimum proportions, while other approaches also have merit"*
    - SMSG suggests that a Call for Evidence should be organised on the sustainability preferences assessment and such alternative approaches – this evaluation would need to place the "average" retail investor in the centre
    - The advice also makes the point that requiring a client to indicate specific sustainability preferences (a, b or c*), "assumes that this client is a rational well-informed investor, which might not be the case"*

SMSG advice: "green-bleaching"

- Green-washing and Green-bleaching
  - Green-washing has been the focus, but the SMSG points to a possible reverse problem of **"green-bleaching"**:
  - This problem emerges where fund managers invest into sustainable activities, but refrain from claiming this is the case in order *"to avoid the data problems arising from the disclosure obligations. If green-bleaching is more pervasive than anecdotal evidence suggests, that would make the current legislation partly irrelevant"*

Non-Financial Misconduct in Financial Services and Parliament

TUESDAY

21 June 2022

8:30 - 9:00 a.m. | Registration
9:00 - 10:30 a.m. | Discussion

Drapers' Hall
Throgmorton Avenue
London, EC2N 2DQ

Latham & Watkins invites you to join us for a lively discussion based on real-life case studies as we address the complexities of non-financial misconduct and consider lessons to be learned from the continuing ‘party-gate’ saga.

This session will explore the relevence of non-financial misconduct within the financial services context, recent legal developments, and ways to establish practical boundaries.

We are delighted to be joined by Beth Rigby, Political Editor at Sky News. Beth has worked as a political journalist for nearly a decade, covering two general elections, the Scottish independence and EU referendums, and all the twists and turns of Brexit.

If you are interested in attending this event, please email *events.london@lw.com*.

Guest Speaker

Beth Rigby
Political Editor
Sky News

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Webcast Series: SMCR Revisited

MONDAY

23 May 2022

12:30 – 1:15 p.m. BST

REGISTER

Monday 23 May 2022

Reasonable Steps

- A brief recap of the avenues of personal exposure under SMCR
- Focus on what ‘reasonable steps’ might look like in practice
- Highlight various practical pointers, case studies, ‘war stories’, and industry insights

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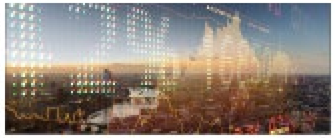

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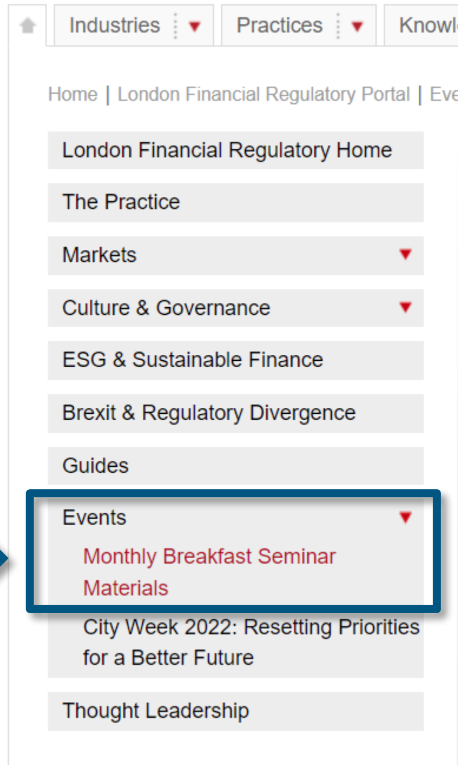

ISSB Announces Working Group and Forum to Coordinate with Country-Specific ESG Reporting Standards

UK Launches Taskforce to Take the Lead in Climate Transition Plans

FCA Finalises Rules to Improve Transparency Around Diversity of Boards and Executive Management

European SPACs: Guide to Regulatory Obligation