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7 December 2022

Financial Regulation Monthly Breakfast Seminar

Overview

- FCA enforcement update
- FCA's proposed new rules on financial advice for mainstream investments
- ESG: fund naming regimes
- Our 10 key regulatory focus areas for 2023

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An FCA enforcement update, including the latest on reasonable steps and the fitness and properness test

David Berman

Non-Financial Misconduct

- No formal definition – but includes:
  - Discrimination
  - Harassment
  - Victimisation
  - Bullying
  - Serious non-financial indictable offences
  - [Any other conduct – whether in or out of the workplace – that calls into question an individual's integrity or reputation, or the reputation of his or her employer]

Contextual Backdrop

- FCA has long since regarded non-financial misconduct as potentially relevant to the integrity and reputation elements of a regulated individual's fitness and propriety
- Since *Burrows* case, there has been a steady stream of cases brought (and bans imposed) by the FCA
- However, in the recent *Frensham* case, the FCA was effectively reined in by the Upper Tribunal from too readily linking (i.e. considering as relevant) non-work-related misconduct to the perpetrator's regulatory fitness and propriety to perform a regulated function

Frensham

- Frensham was an IFA. Convicted of child grooming offence. FCA argued he was not F&P {lack of integrity} and sought to impose a prohibition
- Upper Tribunal: Distinction to be drawn between personal integrity and professional integrity
- ***"A key consideration is the severity of the risk which the individual poses to consumers and to confidence in the financial system, thus providing a direct link to the [FCA's] statutory objectives … In our view, when considering the relevance of behaviour that takes place in a person's private life, the key issue is whether the behaviour concerned realistically engages the question as to whether the individual poses a risk to consumers and to confidence in the financial system"*** {Upper Tribunal}

Frensham (2)

- FCA argued that Frensham's offence created *"a significant risk that he would likewise seek to exploit vulnerable clients (such as the elderly) who seek to rely on him"*
- However, the Upper Tribunal was unpersuaded and regarded this argument as *"speculative and unconvincing"*, in the absence of any supporting criminological or psychological evidence

Frensham (3)

- With regard to the FCA's integrity objective, the Upper Tribunal accepted that this embraced public confidence in the financial services industry and in that context whether there is a significant risk that the confidence of consumers will be impaired if it is known that a person guilty of an offence of this nature is allowed to work as a financial adviser
- The Upper Tribunal stated that the FCA "was clearly entitled to take into account the nature of the offence in considering the effect it has had on Mr Frensham's reputation and the reputation of the industry as a whole. Mr Frensham's personal reputation has clearly been severely damaged as a result of the offence. **But the question is whether the offence affects the reputation of Mr Frensham as a financial adviser and therefore potentially has an impact on the FCA's integrity objective**." The FCA's mere assertions in this regard were not supported by evidence

Frensham (4)

- According to the Upper Tribunal, Frensham's conviction alone was not sufficient to warrant a prohibition order. However, due to the facts that: (i) Frensham had not been open and cooperative with the FCA; and (ii) he had been on bail for another offence at the time, the Upper Tribunal upheld the prohibition

Zahedian

- Mr Zahedian was the sole director of an FCA-regulated consumer credit firm and an FCA-approved person
- Whilst an approved person, Mr Z was involved in an altercation at a bar, during which he used a machete to assault (and wound) a security guard.
- Pleaded guilty to one count of wounding with intent to cause GBH and one count of possession of a machete in a public place. Sentenced to 3 years imprisonment
- Appears to have been provoked; judge considered Mr Z's actions as out of character and that Mr Z would not repeat his actions in the future
- FCA imposed ban on Mr Z – underpinned by finding of a severe risk of an erosion of reputation of, and public confidence in, the financial services sector

Zahedian (2)

- Mr Z did not appeal – however, if he had have done, it is not clear (on the face of the Final Notice) how the FCA would have overcome the thresholds referenced in the *Frensham* judgment (including the evidential requirements)
- Mr Z's offence was, in various respects, arguably of less (regulatory) relevance than that of Mr Frensham (no abuse of trust or exploitation)
- Mr Z's offence was not pre-meditated, he showed remorse and would not re-offend (according to the judge)
- FCA got lucky that Mr Z did not appeal?

- https://www.lw.com/en/offices/admin/upload/SiteAttachments/FCA-Approach-Non-Financial-Misconduct-Latest-Cases-Observations.pdf

Background: FCA action re Sonali Bank

- The FCA identified issues with AML compliance at Sonali Bank (UK) (SBUK) in 2010 and 2014
- A remediation plan was implemented, which subsequently failed to effectively address the issues
- A skilled person was appointed and found that there were systemic AML failings arising from a lack of understanding and implementation of the required compliance systems and controls

Background: FCA action re Sonali Bank

- On 12 October 2016, the FCA published two Final Notices:
  - £3,250,600 to SBUK and imposing a restriction preventing it from accepting deposits for new customers for 168 days
  - £17,900 to the former MLRO and prohibiting him from performing the MLRO or compliance oversight function at regulated firms
- In 2018, FCA published a Decision Notice against Mr Prodhan – fining him £76,400 for acting without due skill, care and diligence and for being knowingly concerned in a breach by SBUK of its obligations to maintain effective anti-money laundering (AML) systems
- Mr Prodhan appealed

FCA Final Notice to Former CEO of Sonali Bank (UK) Limited

- The FCA issued a Final Notice to the former CEO of SBUK, Mr Prodhan, for AML failings for a period running from 2012 to 2014.
- The Final Notice provides a reminder to firms of the FCA's expectations in relation to:
  - Expectations for senior management oversight of staff (for example in relation to the MLRO and AML processes) – including as to "reasonable steps";
  - the individual accountability of the senior manager tasked with overseeing the firm's AML and financial crime compliance; and
  - the importance of senior management engendering a strong compliance culture

Mr Prodhan's responsibilities and failings

- Mr Prodhan held the CF1 (director) and CF3 (chief executive) controlled functions
- Mr Prodhan was also the senior manager with responsibility for the establishment and maintenance of effective AML systems and controls at SBUK, in accordance with SYSC 6.3.8R
- Despite being entitled to delegate day to day operational management, Mr Prodhan remained responsible for ensuring these were functioning well.
- He failed to take reasonable steps to ensure he had an adequate understanding of the firm's AML risks and how they were being addressed
- Mr Prodhan failed to hold sufficiently regular meetings with the MLRO, failed to identify that the MLRO role was under-resourced, and made insufficient contributions to meetings where AML issues were discussed

Mr Prodhan's responsibilities and failings

- Mr Prodhan failed in setting the SBUK's values, culture and standards including in steering senior management towards ensuring a strong compliance culture throughout SBUK
- Because of his failings, staff did not appreciate the importance of AML obligations or the value of complying with them; and (ii) a culture persisted which was resistant to changing business practices in light of regulatory developments
- Mr Prodhan received clear indications from SBUK's internal audit function of issues with the firm's governance framework and AML systems and controls and failed to consider these warnings and take adequate measures to address these concerns

The FCA's conclusions

- The FCA concluded that Mr Prodhan had breached Statement of Principle 6 for approved persons (exercising due skill, care and diligence in managing the business of the firm for which he was responsible)
- Mr Prodhan was also found to be knowingly concerned in SBUK's breach of Principle 3 (a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems)

The FCA's conclusions

- The £76,400 fine was replaced with a public censure because of a change in circumstances of Mr Prodhan:
  - He no longer lives in the UK
  - He recently retired from employment
  - Has ongoing personal conditions which limit his ability to travel to the UK to participate in the Upper Tribunal hearing
  - Approximately 10 years has elapsed since his misconduct, and the time that has elapsed increases the risk of the hearing not being determined fairly

Points to note for firms and Senior Management

- Ensuring that relevant responsibilities and reporting lines are clearly defined and well understood – particularly, where the roles of SMF 17 and MLRO are performed by different persons
- Working with SMF 17s to review the FCA's findings on Mr Prodhan's reasonable steps failings
- Reviewing AML and broader financial crime risk assessments, policies and procedures, and training programmes to ensure they are up to date
- Check that firms have robust policies, procedures, systems and controls in place as well as sufficient management information going to the board
- Reminder of the FCA's cultural expectations of CEOs

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FCA's proposed reforms (CP22/24) to its rules to encourage firms to provide, and consumers holding excess cash to seek out, financial advice for mainstream investments

Jonathan Ritson-Candler

FCA publishes consultation on broadening access to advice in relation to investing mainstream investments

- On 30 November 2022, FCA published CP 22/24 setting out proposals to create a new “core investment advice” regime
- FCA looking to address concerns that consumers are not benefitting from financial advice (too expensive, firms unwilling to utilise current flexibility in rules to offer simplified, lower cost advice) which has led to a significant proportion of consumers with investable assets of over £10,000 being held in cash (and being devalued as a result of inflation)
- FCA concerned that investors are turning to higher risk investments such as mini-bonds, CfDs and cryptoassets

FCA publishes consultation on broadening access to advice in relation to investing mainstream investments

- Aim of proposals is to make certain limited amendments to Handbook rules and supplement with "non-Handbook guidance" to encourage firms to offer "core investment advice" with fewer frictions for clients and less onerous regulatory burden for firms
    - Regime only includes mainstream investments in stocks and shares ISA wrappers
- Consultation closes on 28 February 2023, with final Policy Statement due to be published in Spring 2023 and the new rules being in force from April 2024

Who is the FCA targeting with these proposals?

- FCA expects the consumers (and therefore advisors) benefitting from the core investment advice regime to be a specific target market, with firms required to filter and triage out unsuitable clients at an early stage
- FCA considers the regime to be suited to the following types of clients:
  - Who hold surplus cash assets and would benefit from investing (CP indicates mass market consumers with at least £10,000 in cash savings)
  - Whose income exceeds their expenditure and are looking for advice on suitable investments for their surplus funds
  - Who generally have fewer assets and would benefit from core investment advice
  - Who are looking to subscribe uninvested excess cash savings into market-based investments
  - Who are not looking for wider areas of financial planning (for instance pension or protection advice) that is not included within core investment advice
  - Which have indicated that they have a time horizon for investing of at least 5 years or more

What is core investment advice?

- New Handbook definition which, broadly, means that “core investment advice” is purposefully narrower than (holistic) investment advice (albeit firms require the same regulatory permission of “advising on investments”) and may only:
  - Be given on investments in a new stocks and shares ISA only
  - Relate to investments up to the annual ISA subscription limit (i.e., £20,000 p.a.) – meaning advice in relation to transfers of larger stocks and shares ISAs accumulated over multiple tax years will not be eligible
  - Be given in relation to certain investment products within a stocks and shares ISA wrapper

What is core investment advice?

- ISA is a wrapper, not an investment product such that a range of products can be held in an ISA each carrying varying degrees of risk. FCA keen to ensure only "mainstream" investments fall within regime. Therefore, the following types of investment product are excluded from the regime:
  - Restricted Mass Market Investments (e.g., non-readily realisable securities such as those in unlisted companies)
  - Non-Mass Market Investments (e.g., speculative illiquid securities, pooled investments in an unauthorised fund)
- FCA otherwise cognisant not to devalue core investment advice meaning it wishes to maintain a "healthy range" of products from lower to higher risk available to advisors to recommend

Consumers will be able to pay for one off advice in instalments

- Proposal to allow consumers to pay for advice in instalments, even where the advice given is transactional (i.e., one off) and there is no ongoing service from the advisor or ongoing subscription to a stocks and shares ISA
- Firms should consider interaction with consumer credit regime and availability of the exemption at Article 60F of the RAO for credit not to amount to consumer credit if certain conditions are met, primarily outstanding amounts: (i) are repaid within 12 months; and (ii) do not attract interest or fees

Consumers will be able to pay for one off advice in instalments

- This also links with the policy objectives of encouraging firms to apply suitability assessments in a way that is proportionate for these target consumers with lower sums to invest
  - Consumers receiving core investment advice on a transactional basis will not be able to receive core investment advice in future years on the investments they made when they initially received advice
  - Rationale being that target market of consumers will have investment horizon of c.5 years
  - FCA interested in feedback as to whether to change this and permit core investment advice on the same investments at a later date as a “gateway to holistic financial advice for those accumulating further cash sums to invest”

Suitability

- No amendments to COBS 9A
- Instead, FCA will develop non-Handbook guidance to outline how firms can undertake a streamlined suitability process with a client
- **Knowledge and experience**: FCA expects target consumers to have little to no K&E, with an emphasis on firms to provide educational materials and to then assess their K&E
- **Financial situation (including capacity for loss)**: firms can simplify the information collection exercise on clients' financial situation (focussing on, for example, evidence that the client has sufficient excess household income per month, does not hold significant debts, have an investment horizon of 3 to 5 years and have cash based assets to cover any unforeseen emergencies – for example 3 to 6 months' usual outgoings)

Training and competence and SMCR

- Core investment advisors must be supervised by an individual with applicable qualifications for TC Activity 4 (i.e., QCF Level 4 Diploma in Regulated Financial Planning)
- FCA will introduce new category TC Activity 4A for core investment advice, with advisors only being required to pass modules that cover:
  - Financial Services, Regulation and Ethics
  - Investment Principals and Risk
- 15 hours CPD annually (as compared to 35)
- Existing SMCR regime will apply, unchanged
  - Advisors certified as fit and proper to provide holistic investment advice will not need to be re-certified to provide core investment advice
  - Regulatory references equally applicable
  - Conduct rules will apply to core investment advisors

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ESMA consultation paper on Guidelines on funds' names using ESG or sustainability-related terms

Anne Mainwaring

ESMA consultation paper on Guidelines on funds' names using ESG or sustainability-related terms

- On 18 November ESMA published a consultation paper in relation to the use of ESG or sustainability-related terms in funds' names proposing that:
  - If a fund has any ESG-related words in its name, a minimum proportion of at least 80% of its investments should be used to meet the environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy, as disclosed in Annexes II and III of SFDR Delegated Regulation
  - If a fund has the word "sustainable" or any other term derived from the word "sustainable" in its name, it should allocate within the 80% of investments to "meet the characteristics/objectives" referred to above at least 50% of minimum proportion of sustainable investments as defined in SFDR as disclosed in Annexes II and III of SFDR Delegated Regulation

ESMA consultation paper on Guidelines on funds' names using ESG or sustainability-related terms

- ESMA is also seeking feedback on:

Minimum safeguards	Minimum safeguards including exclusion criteria defined in the Benchmark Regulation are recommended for all investment funds using an ESG or sustainability-related term in their names (which includes, by way of example, exclusions in relation to companies involved in any activities related to controversial weapons and companies involved in the cultivation and production of tobacco)
Index funds	If funds designate an index as a reference benchmark, ESMA seeks views on requiring the proposed 80% and 50% (as applicable) thresholds to be met by the fund before it can use ESG/sustainability-related words in its name. This requirement would present a particular challenge for passive managers reliant on third-party ESG indices
Impact funds	The terms "impact" or "impact investing", or any other impact-related term in a fund name, should only be used if the fund meets the proposed 80% and 50% (as applicable) quantitative thresholds above. In addition, the investments under these minimum thresholds need to be made with the intention to generate "positive" and "measurable" social or environmental impact alongside the financial return

Examples of ESG / sustainability-related terms

- Some of the terminology considered in the proposals (including the examples in the Annexes to the consultation paper) deal with fund names including the following:
  - Sustainable
  - Impact
  - Climate change
  - Water (in combination with “sustainable”)
  - Biodiversity
  - Society (in combination with “sustainable”)

Timing

- ESMA's consultation closes on 20 February 2023
- A final version of the proposed rules is expected by Q2 or Q3 2023
- A six-month transition period is also proposed for funds launched prior to the proposed rules coming into effect if those funds use ESG or sustainability-related terms in their names. These funds will then have to bring their investments in line with the quantitative thresholds or change their names to remove ESG/sustainability-related terms

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Our 10 key regulatory focus areas for 2023: trends, challenges and expectations for the year ahead

Rob Moulton

1. ESG

- Major area of focus: legislative change, and managing greenwashing risk
- EU
  - More detailed Level 2 requirements under SFDR
  - Refinements to existing regime e.g. Article 8
- UK
  - Mandatory TCFD disclosures across the market
  - Intent on operating at global (rather than European) level
- Globally
  - ISSB Standards
  - Some US states heading in the opposite direction

2. Divergence and rule reform

- Background: equivalence, and rule making versus rule taking
- Pace of change: Capital Markets reform versus Secondary Markets tinkering
- Bonus cap removal – a key political test case
- Parliamentary process: the Bill, and the (non)call-in power

3. Consumer protection and the Consumer Duty

- A perfect storm for firms in this area
  - Cost of living pressure from customers and regulators
  - Political pressure / regulatory reform?
  - Implementation of the Consumer Duty (which predated cost of living issues)
- A dangerous combination of detailed rules, an outcome focused regulator, and ad-hoc industry specific directions (e.g. CFD industry Dear CEO letter)

4. Conduct and culture

- Rightly a key area of focus for regulators, especially the FCA
- A driver and mitigant of risk
- Inconsistent approach at the FCA
  - To their own employees?
  - To their approach to matters in the courts (Frensham and Zahedian)

5. Overseas person exclusion reform

- Confusion (including at regulators) between the Exclusion (RAO) and the Rule ("in the UK")
  - CFD industry Dear CEO letter
- Law of unintended consequences is at play
- Focus on location of clients runs contrary to history / tax
- An area of possible climb down?

6. AML and financial crime

- Focus has shifted from firms, to individuals as well as firms
- Rule divergence with the EU
  - UK registration of foreign ownership
  - Creation of pan-European authority in the EU
  - Approach to risks posed by crypto assets
- Continued political push *against* current strict approach to PEPs

7. Diversity and inclusion

- More progress is needed – complacency is a risk, says the FCA
- Includes diverse needs of customers
  - Cost of living impact, and linked to Consumer Duty
- Increased focus on socio-economic biases
- Major paper expected from HMT / PRA / FCA Q1 2023

8. Ephemeral messaging in hybrid world

- A major news item for the industry in 2022 (even though the issue is now “old”)
- How to assert control over future developments of systems with no current communications mechanism
- Is this the Forth Bridge of regulatory projects?
- Semi-co-ordinated approach by regulators in US, UK, Germany, Hong Kong etc.

9. US research – no action letter expiry

- Upcoming deadline - July 2023 will see the end of SEC's relief under the no-action letter which permitted US broker-dealers to accept hard dollar payments from EU asset managers (or their sub-advisers) without registering as investment advisors
- US-EU regulatory divergence
- Imperfect solutions so far, but be prepared in advance of the deadline

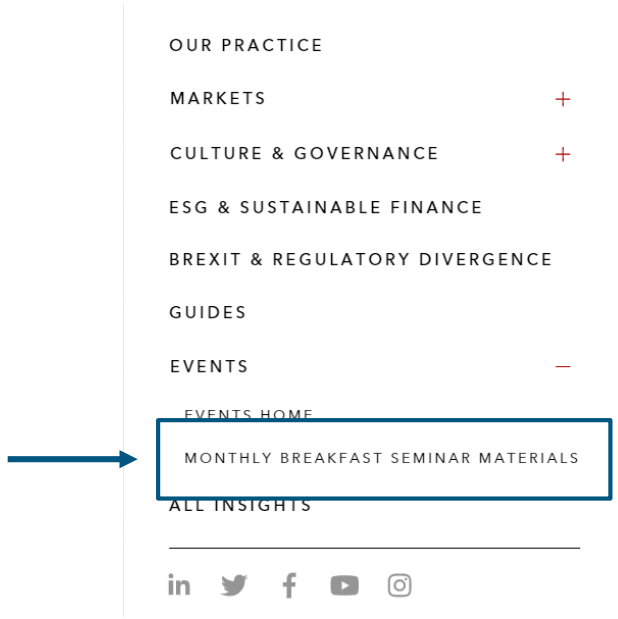
10. CTP reform

- A key UK regulatory initiative with broad government backing
- Novel in regulatory terms (rules for parts of businesses outside the UK that have a UK impact) and flexing of regulatory muscle overseas
- Initiatives in other jurisdictions preceding, including EU
- Impact of negotiations between industry and providers

Coming Soon: 10 Key Focus Areas

This annual publication outlines some of the primary focus areas in 2023 for UK-regulated financial services firms. The fundamental consideration of the direction of travel of UK financial services regulation has progressed, and this is borne out across many of the topics covered in this year's publication.

Recent Thought Leadership

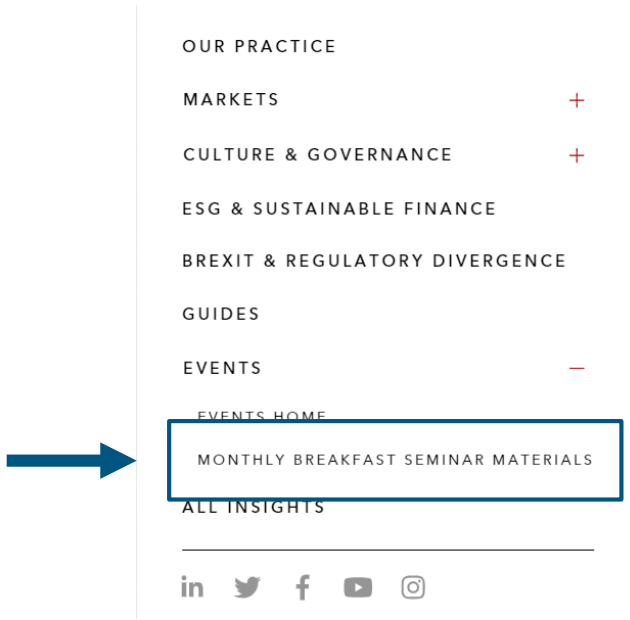


[FCA Issues Final Notice to Former Banking CEO Over Anti-Money Laundering Failures]

[The FCA's Approach to Non-Financial Misconduct]

[ESMA Issues Consultation Paper on Fund Names to Tackle Greenwashing]

London Financial Regulatory Portal



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