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Regulatory Focus

Issue 124

In this edition of Regulatory Focus, the experts in Duff & Phelps' UK Compliance and Regulatory Consulting team, provide a detailed synopsis of the latest news and publications issued by the Financial Conduct Authority during April 2019.

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FCA sets out its priorities for 2019/2020

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The FCA published its Business Plan for 2019/20, outlining its key priorities for the coming year.

The immediate priority of the FCA will remain supporting an orderly transition after the UK leaves the European Union, however the FCA will also continue to play a leading role in shaping the global regulatory framework, by working with other national regulators and international bodies.

The Business Plan outlines four ongoing cross-sector priorities:

- Work on firms' culture and governance, including extending the Senior Managers and Certification Regime to all firms.
- Ensuring the fair treatment of firms' existing customers by monitoring firms' practices, including the information they give prospective and current customers.
- Developing the work being done on operational resilience, which will play a vital role in protecting the UK's financial system.
- Combating financial crime and improving anti-money laundering practices, by enhancing the use of technology and data, as well as engaging with multiple agencies and government bodies.

The plan also sets out three additional longer-term cross-sector priorities:

- The future of regulation and ensuring the regulatory landscape is fit for the challenge it faces.
- Ensuring innovation, together with advances in technology and data use, works in consumers' interests.
- Examining the intergenerational challenge in financial services, how the industry might respond and how regulation may need to change.

Alongside the Business Plan, the FCA is also publishing its annual Consultation Paper on fees and a paper setting out the FCA's Research Agenda.

Dear CEO letter – Wholesale Market Broking

18 April

The FCA issued a letter on its website addressing the CEOs of all regulated broking firms in the wholesale markets sector. The purpose of the letter is to covey the FCA's views of the four key drivers of harm posed to clients and markets in this sector, as summarised below:

- Compensation and incentives
- Governance and culture
- Capacity of conflicts of interest
- Market abuse and financial crime controls

The letter calls on Senior Management of brokerage firms to promptly consider how to address and mitigate the above issues identified. The FCA confirms that it will continue its focus in this area for the next 2 years. After March 2021, the FCA will publish an update on its views of the key risks firms in this sector pose, as well an updated supervisory strategy.

The FCA confirms that brokers need to prioritise raising their standards to embed a culture of good conduct. Simon Walls, Head of Wholesale Markets Department, says of wholesale brokers "…we continue to see a complacent attitude and resultant failure to meet expectations across all areas of regulation we have recently examined".

Firms are reminded to raise any questions with the FCA. In the case of urgent issues of strategic importance, firms can contact Simon Walls or Baljit Bhamra (Wholesale Brokers team manager) directly.

To read the letter in full, click here

The European Securities and Market Authority (ESMA) publishes MIFID II supervisory briefing on appropriateness and execution-only

4 April

ESMA published an updated version of its supervisory briefing on MiFID II appropriateness requirements.

This supervisory briefing is an updated version of ESMA's 2012 supervisory briefing on the same topic. It considers the new version of ESMA's guidelines on suitability published on 28 May 2018 with respect to aspects also relevant to the appropriateness rules.

The appropriateness rules apply to investment firms when they are providing MiFID investment services other than investment advice or discretionary portfolio management services. The MiFID II appropriateness requirements, as set out in Article 25(3) of MiFID II, require that firms must ask the client, or potential client, to provide information regarding that person's knowledge and experience in the investment field relevant to the specific type of investment product or service offered or demanded, to assess whether the investment service or product envisaged is appropriate for the client in question.

The ESMA supervisory briefing covers the following topics:

- Determining situations where the appropriateness assessment is required;
- Obtaining information from clients;
- Assessment of appropriateness;
- Warnings to clients;
- Qualification of firm's staff; and
- Record-keeping.

While this supervisory briefing is aimed at competent authorities, it also aims to give market participants indications of compliant implementation of the MiFID II appropriateness provisions. The purpose of this supervisory briefing is to promote common supervisory approaches and practices amongst EU Member States in the application of the MiFID II appropriateness rules. The full ESMA supervisory briefing can be found here.

Mark Steward, Director of Enforcement and Market Oversight at the FCA delivered a speech at the Global Investigations Review Live event.

4 April

Mr. Steward delivered his speech at the 5th Annual Global Investigations Review Live event in London. His speech focused on three main areas:

- An overview of the partly contested case process and the role of the Regulatory Decisions Committee (RDC) in this process. This included an overview of the three completed cases that have thus far gone through this process.
- A sample of recent decisions that demonstrated the following:
  - Firms will be held accountable for causing harm that was, or should have been, foreseeable;
  - Reasonable systems and controls need strong escalation protocols to be effective; and
  - In assessing whether senior managers have taken reasonable steps to prevent a breach, poor escalation protocols and inadequate sight lines into the heart of the business will be considered.
- The large number of ongoing investigations tackling some very serious issues including suspected financial crime, *suspected false or misleading statements by listed issues and suspected significant AML system and control issues under the Money Laundering Regulations*.

Mr. Steward's full speech can be found here.

FCA fines Bank £102.2 million for poor AML controls

9 April

The FCA has issued its second largest financial penalty for Anti-Money Laundering (AML) control failings.

The FCA investigated two areas of the business which the Bank initially identified as being high risk. The business areas were the Wholesale Bank Correspondent Banking business and its branches in the United Arab Emirates (UAE). The FCA investigation identified serious shortcomings in the customer due diligence and ongoing monitoring. The Bank failed to maintain risk sensitive policies and did not ensure that the same AML and counter-terrorist financing controls were in place for all the UAE branches.

Under the Money Laundering Regulations 2007, the Bank was required to establish and maintain appropriate levels of risk sensitive policies to counteract and reduce the risk of any activities that may harm the institution, such as laundering money for the proceeds of crime, evading financial sanctions or financial terrorism.

The FCA found shortcomings in the Bank's internal assessments of the adequacy of its AML controls, identification and mitigation money laundering risks and escalation of risks.

Examples included:

- Opening an account with 3 million UAE Dirham in cash in a suitcase with little evidence that the origin of the funds had been investigated.
- Failing to collect sufficient information on a customer exporting a commercial product which could potentially have a military application. This product was exported to over 75 countries, including two jurisdictions where armed conflict was taking place or was likely to be taking place.
- Not reviewing due diligence on a customer despite repeated red flags such as a blocked transaction from another bank, indicating a link to a sanctioned entity.

The periods of the failings in the Correspondent Banking business occurred between November 2010 to July 2013 and the failings from the UAE branches between November 2009 to December 2014.

The US authorities have also acted against the Bank due to the numerous violations of US sanction laws.

Mark Steward, Director of Enforcement and Market Oversight at the FCA, said that the breaches were particularly serious as they occurred against a backdrop of heightened awareness of AML risk following specific attention from the FCA, US agencies and other global bodies about such risks.

The full article can be read here.

The Upper Tribunal has published its decision in relation to a penalty imposed by the FCA, in the first case considered under the partly contested cases process.

10 April

The partly contested cases process allows firms or individuals under investigation to enter into a contract called a Focused Resolution Agreement (FRA), which enables them to agree to certain elements of a case, whilst disputing others.

In this instance, the FCA had issued a Decision Notice in relation to a firm's failure to "take reasonable care to organise and control its affairs responsibly and effectively to ensure potential instances of market abuse could be detected and reported". The Firm had believed, mistakenly, that it could rely upon post-trade surveillance undertaken by brokers through which it executed transactions for detecting market abuse, instead of undertaking its own surveillance.

The Firm agreed to the matters of fact and liability set out in the Decision Notice, however it disputed the penalty of £409,300 imposed by the FCA. The Upper Tribunal considered the case and agreed that the FCA's penalty was appropriate.

In its press release Mark Steward, Executive Director of Enforcement and Market Oversight at the FCA explained that firms are: "expected to play their part in tackling market abuse by ensuring that they are able to identify and manage the market abuse risks to which they are exposed".

The FCA's Press Release can be found here.

EU Financial Regulators highlight risks of a no-deal Brexit and Asset price volatility

2 April

The latest report on "Risks and Vulnerabilities in the EU Financial System", published by the Joint Committee of the European Supervisory Authorities ("ESAs"), has shown that the EU's securities sector continues to face a range of risks, highlighting the following as potential sources of instability:

- Uncertainties around the terms of the UK's withdrawal from the EU.
- Further re-pricing of risk premia and asset price volatility, which could be aggravated by a less favourable macro-economic environment and a no-deal Brexit scenario.

As a result of the ongoing uncertainties, supervisory vigilance and cooperation across all sectors remains crucial. Therefore, the ESA has called for European and national competent authorities ("NCAs"), as well as financial institutions, to put in place contingency plans and stress testing scenarios.

Contingency Plans: It is crucial that EU financial institutions, market participants and their counterparties enact timely contingency plans to prepare for the UK's withdrawal from the EU, including the possible market volatility that a no-deal Brexit may cause. The ESA has issued Opinions and Recommendations to provide important guidance for financial institutions, market participants and NCAs with regards to a potential no-deal scenario.

Stress Tests: With the potential for sudden risk premia reversals and a risk of rising funding costs, the development and regular use of stress tests across all sectors remains vital. ESMA will present guidelines on fund liquidity and Money Market Fund stress testing during 2019. ESMA is also preparing its next Central Counterparties ("CCPs") stress test.

The full article can be read here.

FCA and Australian Securities and Investments Commission agree to strengthen cooperation post-Brexit.

8 April

The FCA agreed two Memoranda of Understanding (MoU) with the Australian Securities and Investments Commission (ASIC) to maintain cooperation and information sharing when UK leaves the European Union.

The first MoU provides for the new framework for the FCA and ASIC to continue adequate supervision in the UK and Australia over alternative investment fund managers ("AIFMs") and AIFs that operate on a cross-border basis.

The second MoU concerning trade repositories is required because the functions and supervisory powers in relation to trade repositories, are currently supervised at the European level by ESMA.

The MoU on trade repositories will ensure that ASIC can continue to access data on derivatives contracts held in UK trade repositories, where the information is needed for ASIC to fulfil its responsibilities and mandates.

Andrew Bailey, Chief Executive, FCA said:

"The FCA and ASIC have always had a strong relationship, which will continue after Brexit. The MoUs we have agreed today will ensure the FCA and ASIC have uninterrupted exchange of information and can supervise cross-border activity of firms. They provide a strong signal to the markets that the UK will continue to play an important role after Brexit. The MoUs will also provide much-needed assurance to our regulated stakeholders."

To read the press release in full, please click here.

Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, delivered a speech on the FCA's approach towards stewardship.

3 April

Mr. Latter's speech, which was delivered at the LSE conference on March 23rd, focused on current stewardship efforts by market participants, the importance of effective stewardship, and how stewardship can be promoted in the future. Mr. Latter highlighted that:

- Effective stewardship, which requires long-term thinking and shareholder engagement, is important to ensuring that markets function well, consumers are protected, and that market integrity and competition are protected and promoted, respectively.
- Though progress has been made towards achieving effective stewardship, evidence on whether and how stewardship is being achieved is mixed.

The FCA needs to consider how best to build upon the baseline for stewardship actions being established by the Shareholders Rights Directive II, which sets out to strengthen shareholders' positions and ensure that decisions are made for the long-term stability of a company.

The full speech can be found here.

Please see our client alert here.

The European Securities and Markets Authority ("ESMA") updates register of derivatives to be traded on-venue under MIFIR

4 April

ESMA updated the public register of derivative contracts subject to the trading obligation under the Markets in Financial Instruments Regulation (MiFIR) following the authorisation of a Dutch venue as a Multilateral Trading Facility.

Under Article 28(1)(d) of MiFIR, counterparties may fulfil the trading obligation by trading on a venue established in a third country. This update also reflects the recent equivalence decision by the European Commission for Singapore.

The register also provides clarity on the application of the MiFIR trading obligation, in particular on:

- The classes of derivatives subject to this obligation
- Trading venues that can be utilized; and
- The date the obligation takes effect for different categories of counterparties

To read the update in full, please click here.

ESMA issues the first overview of pan-European supervisory sanctions for UCITS

4 April

The Undertakings for Collective Investments in Transferable Securities ("UCITS") Directive allows national competent authorities ("NCAs") to impose sanctions for infringements of its provisions. In April the European Securities and Markets Authority (ESMA) issued its first annual report of these sanctions.

The report contains an overview of the applicable legal framework and information on the sanctions imposed by NCAs between 1 January 2016 and 31 December 2017, including:

- Total number and amount of penalties, by NCA and by UCITS chapter.
- Total number of measures, by NCA and by UCITS chapter.
- NCAs that have issued no sanctions.

The full report can be found here, and the ESMA press release can be found here.

FCA publishes feedback statement on Duty of Care

19 Aprill

An FCA feedback statement was issued in summary to the responses received from its Discussion Paper back in July 2018 on 'A duty of care and potential alternative approaches' and setting out next steps.

As a result of the feedback, it has identified options for change that are most likely to address potential deficiencies in consumer protection.

These are:

- Reviewing how it applies the regulatory framework- in particular, its application of the Principles in its authorisations, supervisory and enforcement functions, and how transparently its communications with firms about this
- New/revised Principles to strengthen and clarify firms' duties to consumers, including considering a potential private right of action for Principles breaches.

To read the article in full along with Andrew Bailey's (FCA Chief Executive) statement, please click here

The future of financial conduct regulation

23 April

The Chief Executive of the FCA, Andrew Bailey, delivered a speech on the future of financial conduct regulation.

Mr. Bailey began his speech by reflecting on the FCA Mission statement which sets out the regulators approach towards meeting its statutory objectives. “Let me go back to 2017 when we published the FCA Mission statement, which continues to be the centrepiece, the glue, that holds together our approach to the large landscape of activity that the FCA covers to meet its statutory objectives. It shapes our culture too, for example we have re-done our statement of values in the light of The Mission. What we did with The Mission was to set out a much-needed framework to explain and interpret why we regulate conduct across the markets for finance”

Focus was given to the importance of regulating in the public interest framework and what that means. Mr. Bailey was in favour of a competitiveness objective supported by a cost benefit analysis alongside the FCA’s competition objective. He said, “If we are going to have the competitiveness debate, let’s please have it in a public interest framework that does not entrench the interests of incumbents”.

In his concluding statements, Mr. Bailey distinguished the importance of principles and outcomes. “An organisation that prioritises being within the rules over doing the right thing, will not stand up to scrutiny for long. My aim is to see that mentality deeply embedded in the culture of firms. As the duty of care debate shows, there are strongly held views on consumer harm, and its incidence. The post-Brexit system cannot and should not seek to deny or ignore them”.

Full speech can be accessed here.

In a recent internal discussion, it was suggested that the continued growth in consumer regulation and tax changes made the UK less attractive. The question was then put to us tax folk whether we agreed with that sentiment and whether the UK's impending exit from the EU might result in adverse material change.

There is no doubt that there have been vast regulatory and tax changes introduced across the EU (and by result into UK domestic law) in an attempt to harmonise cross border operations and protect consumers and the tax base from egregious behaviour.

From a regulatory perspective, the changes introduced to the UK include AIFMD, MiFID II, MAR, GDPR, SMCR, PRIIPS which have substantially increased the reporting and compliance burden for firms. This swell in regulation creates additional barriers to entry for new firms entering the UK market as well as imposing further challenges for smaller firms already struggling in the current environment. The risk is that this increased regulation results in the UK having a less competitive environment and lost investment and revenue.

The UK Tax Landscape

Yet, from a tax perspective, the picture is somewhat different. Whilst its clear there have been substantial legislative amendments targeted at the investment management industry (Disguised Investment Management Fee (DIMF) provisions, changes to the taxation of carried interest returns and revision to the non-domicile regime) these were mainly introduced as anti-avoidance measures seeking to combat certain egregious behaviour and ensure closer alignment across certain sectors of the economy. While these changes have undoubtedly increased the tax burden on individuals, the UK's approach to attracting foreign investment is different.

It might come as a surprise to some, but in the past 10 years, the UK done a remarkably good job of creating an attractive holding company environment. A good holding company / investment location includes several critical hallmarks:

1. A comprehensive tax treaty network;
2. A domestic 'participation exemption' that allows dividends and capital gains to be exempt from tax on receipt
3. A low corporate tax rate on other forms of income
4. Incentives for entrepreneurs and start up entities
5. Low rates of withholding tax of cash repatriation
6. An attractive city with good restaurants, culture and history (vitally important!)

As set out below, the UK ticks all the boxes.

a. The UK rewards long term investment through the substantial shareholding exemption (SSE) that exempts gains from tax. Recent amendments to the 'holding period' requirement have made the qualifying conditions easier to satisfy. Whilst the UK rules are not as flexible as other European jurisdictions (when compared to Luxembourg and Netherlands that have shorter holding period requirements) the EU is forcing its Member States to strengthen their rules, thereby levelling the playing field.

b. Distributions paid to UK companies are exempt from corporation tax in most circumstances. In addition, the UK does not impose withholding tax on company's making dividend payments to overseas parents. Whilst UK entities may be required to withhold tax on some interest payments, there are several simple steps that can be taken to ensure payments made be made without deduction (i.e. listing of loan notes on a recognised stock exchange).

c. As part of the introduction of the revised controlled foreign company regime introduced in 2013, a 75% exemption was included for UK headquartered groups that operated a non-UK finance / treasury company. The rules are extremely beneficial. However, recent challenges by the European Commission as to whether the finance branch exemption constitutes illegal state aid may prove problematic.

d. Unique to the UK is the Investment Manager Exemption (IME) regime that seeks to ensure that where UK based investment managers manage offshore funds, the profits of those fund are not subject to UK tax (as they would be under general principles). To qualify, a number of conditions must be met including that the fund should be paying the investment manager an arm's length (commercial) fee for the services that it performs, the fund should be trading, and the investment manager should not be entitled to more than 20% of the profits of the fund. The IME is one the primary drivers behind the growth of London as an investment management hub.

Winds of Change

Yet, while the UK has done a good job in producing a tax environment that meets the established hallmarks, the worldwide attitude to tax planning and transparency has changed markedly.

To promote a transparent commercial environment and a closer degree of harmonisation between domestic tax systems, the OECD drafted the Base Erosion and Profit Shifting (BEPS) Actions. The Actions include provisions that domestic tax systems should include to protect the tax base. However, because the implementation of BEPS is voluntary, and, given the EU's push for ever closer alignment, the Anti Avoidance Tax Directive ('ATAD') makes the adoption of the certain BEPS measures mandatory for all 27 Member States.

The ATAD provisions are split between ATAD I and ATAD II that impose different rules. Whilst most of the provisions apply from 1 January 2019, some of the rules will be introduced in stages over the next few years (most relevant being the cross-border hybrid provisions).

The ATAD provisions

The five legally-binding anti-abuse measures, that seek to minimise aggressive cross border tax planning, enhance transparency and limit scope for arbitrage included in ATAD are:

- Interest Limitation – this introduces a 30% EBITDA restriction on the deductibility of excess borrowing costs
- Exit taxation – imposes a tax charge as result of a transfer of a trade or business from EU Member States
- General Anti-Abuse Rule - aimed at counteracting artificial or egregious tax arrangements
- CFC Rules – to deter profit shifting to low tax jurisdictions
- Hybrid mismatches – aimed at preventing double deductions or non-inclusion of income as a result of hybrid entities or hybrid instruments.

While the UK is subject to the EU's ATAD rules, given the 'maturity' of the UK tax system, the impact on the UK will be rather limited.

Brexit

However, as we are all patently aware, the UK has voted to leave the EU and possibly withdraw from the common market. The most recent extension of the deadline expects the UK to leave the EU on 31 October 2019.

Should the UK leave the EU on this date without a deal, from a tax perspective, the immediate impacts are likely to be rather limited. The UK will fall out of the various EU Directives that allow tax free transfer of dividends, interest and royalties. However, the UK's broad tax treaty network (that predates the EU Directives) should achieve the same or similar result.

The more interesting question (and perhaps more worrisome for the EU) is whether the UK will decide to pursue a domestic tax policy that is decidedly un-EU (lower taxes, lower tariffs, competitive regulatory environment). Should the UK leave the EU as part of a no deal Brexit, such that it will no longer be required to adopt legislation in line with the EU (i.e. ATAD) it could pave the way to create an even more competitive regulatory and tax environment.

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OUR RECENT AWARDS

BEST FINANCIAL SERVICES TAX PRACTICE
Tolley's Tax Awards 2019

BEST COMPLIANCE CONSULTANCY
CTA intelligence Awards 2018

ADVISORY AND CONSULTANCY: TAX
Drawdown Private Equity Services Awards 2018

BEST ADVISORY FIRM – REGULATON AND COMPLIANCE
HFM Week 2018

BEST GLOBAL CYBERSECURITY SERVICES PROVIDER
Hedgeweek Global Awards 2018

BEST COMPLIANCE CONSULTING TEAM
Women in Compliance Awards 2017

BEST GLOBAL REGULATORY ADVISORY FIRM
Hedgeweek Global Awards 2017

EUROPEAN SERVICES - BEST CONSULTANCY FIRM
CTA Intelligence 2016

BEST EUROPEAN OVERALL ADVISORY FIRM
HFM Week 2016

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