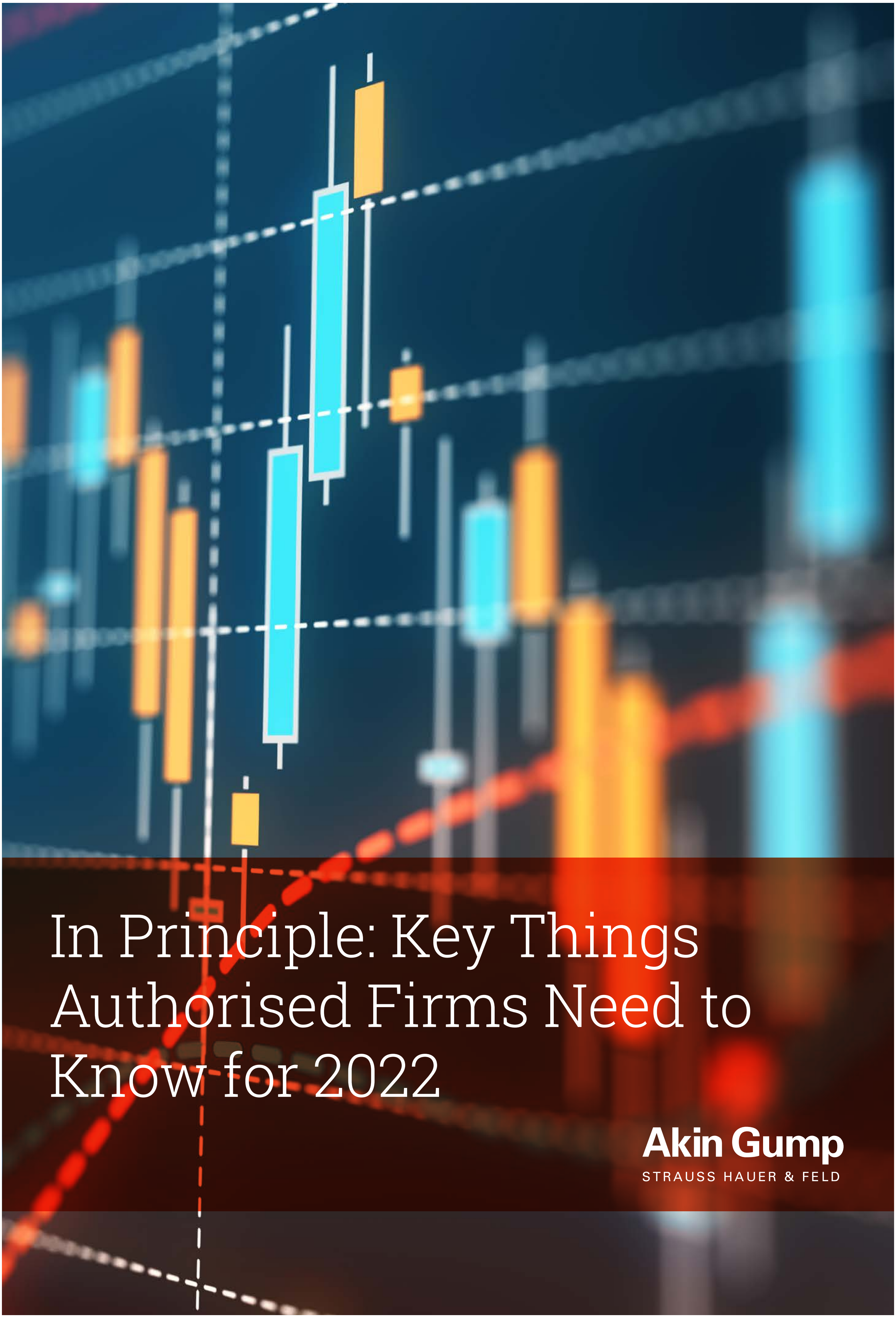

In Principle: Key Things Authorised Firms Need to Know for 2022

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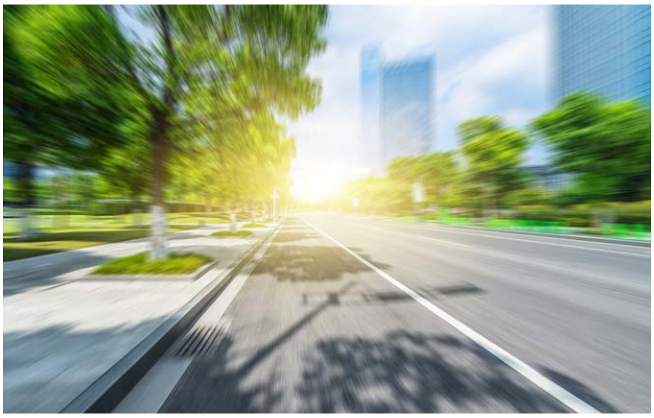
1. The SFDR and the Taxonomy Regulation: Key Developments and What Firms Can Expect in the Coming Year

Almost a year on from the date on which the European Union's Sustainable Finance Disclosure Regulation (SFDR) came into force on 10 March 2021, the market interpretation of the new environmental, social and governance (ESG) rules is beginning to settle, but the hard work is not over as firms will need to continue to focus on their internal arrangements to obtain the data they need, and find ways to identify or create appropriate proxy data. The SFDR saw introduction of the product categories, and the attendant disclosure requirements under the SFDR for the product and the product provider, as well as the environmental sustainability classification system under the Taxonomy Regulation. The delayed application of key provisions under the long-awaited secondary legislation (providing additional colour on the requirements under the SFDR and the Taxonomy Regulation) (RTS) to 1 January 2023[1] provides more time to prepare for the more detailed disclosures. However, the absence of meaningful data and guidance regarding acceptable proxy data, and the absence of technological solutions allowing firms to more effectively harness their proprietary data and enrich it with relevant external data from sustainability ratings providers and others continues to complicate compliance.



The Devil in the Detail – Secondary Legislation

While the relatively high level requirements and flexible definitions under the SFDR have allowed for the prescribed disclosures to include more or less detail, and the broad definition of "Article 8" products has meant that products categorised under Article 8 of the SFDR may include material differences of degree in terms of commitment to ESG strategies, the much more granular and quantitative provisions under the RTS are likely to be more revealing of the ESG credentials of a product. The same is true also with respect to the subset of Article 8 and Article 9 products that are subject to the additional disclosures under the Taxonomy Regulation.

The RTS sets out, among other things, details of:

- Information required to be disclosed for an investment to satisfy the "do no significant harm" test pursuant to the SFDR (which is distinct from the "do no significant harm" test under the Taxonomy Regulation – see below)—in order that it may qualify as a "sustainable investment" within the context of the SFDR, provided such investment also contributes to an environmental or social objective under the SFDR.
- The key performance indicators required to be considered to make the Principal Adverse Impact (PAI) disclosures. These are heavily prescribed quantitative data fields which firms must populate to complete the disclosure.
- Prescribed content requirements for each item of information that must be included in the pre-contractual disclosures and website disclosures in respect of financial products that fall within the definition of Articles 8 and Article 9 of the SFDR, and their providers.

1 The mandatory entity-level requirements for reporting of the PAI of investment decisions was not delayed and took effect from 1 January 2022. Similarly, the requirement under MiFID to report on sustainability preferences is set to take effect from 2 August 2022 without delay.

- Prescribed content requirements for each item of information that must be included in the periodic reports under Article 11 of the SFDR in respect of financial products that fall within the definition of Article 8 and Article 9 of the SFDR.
- Prescribed content and presentation requirements for the additional information required to be included in the pre-contractual disclosures and periodic reports in respect of the sub-set of financial products under each of Article 8 and Article 9 of the SFDR that make "environmentally sustainable" investments within the meaning of the Taxonomy Regulation.

While regulatory guidance to date has indicated that firms should comply with the primary requirements on an evidenced best efforts basis, taking into account the provisions under the SFDR RTS until the relevant provisions under the SFDR RTS take effect, the regulatory initiatives are only starting to focus on harmonising the production of ESG and sustainability related market data, including ratings, and has provided no satisfactory response to how firms struggling with plugging gaps in the investment level data.

The Gold Standard – the Taxonomy Regulation

The Taxonomy Regulation, which takes effect in stages from 1 January 2022, introduces additional disclosure requirements, particularly in respect of Article 8 and Article 9 products. In addition, it introduces the standard for a harmonised assessment of what it means for an investment to be "environmentally sustainable" as the term is used in the EU.

An "environmentally sustainable" investment under the Taxonomy Regulation is defined as "an investment in one or several economic activities that qualify as environmentally sustainable under [the Taxonomy Regulation]". There are four key tests that an economic activity must satisfy to be "environmentally sustainable" under the Taxonomy Regulation. The activity must:

- "Contribute substantially" to at least one of the environmental objectives under the Taxonomy Regulation.
- "Do no significant harm" to any of the other environmental objectives.
- Be carried out in compliance with minimum social and governance safeguards.
- Comply with the relevant technical screening criteria.

The technical screening criteria required to be adopted (via delegated legislation) under the Taxonomy Regulation will prescribe the granular requirements for determining the conditions under which an economic activity qualifies as "contributing substantially" to the relevant environmental objective(s) and whether that economic activity "does no significant harm" to any of the other environmental objectives.

An investment may therefore qualify as a "sustainable investment" within the meaning of the SFDR but is required to separately meet the arguably more stringent requirements to qualify as an "environmentally sustainable" investment within the meaning of the Taxonomy Regulation.

Climate Change Delegated Regulation

Following a period of feedback and consultation, on 9 December 2021, the European Commission adopted a proposed Delegated Regulation (the "Climate Change Delegated Regulation"),[2] containing the technical screening criteria for determining:

- The conditions under which an economic activity qualifies as "contributing substantially" to climate change mitigation or climate change adaptation.
- Whether that economic activity "does no significant harm" to any of the other environmental objectives.

The Climate Change Delegated Regulation comes into effect on 1 January 2022, though given the delay to general applicability of the RTS, it remains to be determined how the results of an assessment of an investment by reference to technical screening criteria will ultimately be disclosed by investment managers.

Possible Taxonomy for Social Objectives

At present, the Taxonomy Regulation sets out the criteria for determining whether an eligible economic activity qualifies as "environmentally sustainable." It is expected that work on developing an EU taxonomy for "socially sustainable" investments will commence in earnest in the following months. The teething problems in rolling out a significant new framework may have eased off by then, hopefully making application of and compliance with such a taxonomy a more straightforward task.

2 See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R2139&from=EN.

2. New UK Sustainability Disclosure Rules

The UK's "Roadmap towards mandatory climate-related disclosures" and "Roadmap to Sustainable Investing"[3] have clearly signalled that, while the United Kingdom will take into account the EU's approach to ESG reporting, it will develop its own rules which will not be a copy-out of the EU's rules.

The UK has introduced a climate-related disclosure regime, which requires TCFD[4]-aligned of disclosure by certain financial institutions, including asset managers, as well as certain UK listed companies. In addition, the Financial Conduct Authority (FCA) announced in its November 2021 Discussion Paper[5] the prospective introduction of a broader sustainability disclosure regime, also applicable to asset managers and other financial institutions, with potentially extraterritorial application.

Climate Change Disclosures

On 17 December 2021, the FCA issued a Policy Statement—including Final Rules—setting out the enhanced climate-related disclosures which would have to be made by asset managers (as well as life insurers and FCA-authorised pension providers).[6] The new rules form a new Sourcebook in the FCA's Handbook, called the "Environmental, Social and Governance Sourcebook" ("ESG Sourcebook").

Scope and Timing

The disclosure rules apply to all FCA-authorised investment managers in relation to their "TCFD in-scope business".[7]

"TCFD in-scope business" includes portfolio management, managing a UK UCITS,[8] managing an Alternative Investment Fund (AIF). For these purposes, "portfolio management" includes advising or managing investments on a recurring or ongoing basis in connection with an arrangement, the predominant purpose of which is investment in unlisted securities. As such, the rules will therefore also apply in certain limited circumstances to FCA-authorised investment advisers, as well as investment managers.

However, firms will be exempt from the disclosure requirements if and for as long as the assets under management in relation to the firm's TCFD in-scope business amounts to less than £5 billion, calculated as a three-year rolling average on an annual assessment.[9]

For asset managers with more than £50 billion assets under management,[10] the rules took effect on 1 January 2022, with the first publication of reports due by 30 June 2023.

For asset managers with more than £5 billion AUM but less than £50 billion, the rules take effect from 1 January 2023, with the first publication of reports due by 30 June 2024.[11]

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1031805/CCS0821102722-006_Green_Finance_Paper_2021_v6_Web_Accessible.pdf.
4 Task-Force on Climate-related Financial Disclosures
5 https://www.fca.org.uk/publication/discussion/dp21-4.pdf.

6 Policy Statement 21/24, https://www.fca.org.uk/publications/policy-statements/ps-21-24-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions.

7 ESG 1.2.1 R. We note that this article focuses on the application to asset managers, and we do not here discuss how the rules apply to other firms such as life insurers and FCA-regulated pension providers.
8 Undertakings for Collective Investment in Transferable Securities.
9 ESG 1.2.2 R.
10 These firms are "enhanced scope SMCR firms", as defined in accordance with SYSC 23 Annex 1: https://www.handbook.fca.org.uk/handbook/SYSC/23/Annex1.html.
11 See ESG TP1 1.1 R.

Reports

Under the new rules, firms will be required to create two different types of report: "TCFD entity reports" (which can be thought of as "Manager Reports"), and TCFD product reports (or "Product Reports"). Both Manager Reports and Product Reports are expected to comply with the TCFD's Recommendations and Recommended Disclosures[12] and the associated Implementation Annex,[13] as well as other TCFD materials.[14] In certain circumstances, firms will also be required to provide "on-demand information" upon request.

Firms must take all reasonable steps to publish the Manager Reports and Product Reports in a way that makes it easy for prospective readers to locate and access. At a minimum, this means making the most recent of these reports available in a prominent place on the firm's main business website.[15]

Reports must be prepared and published annually by 30 June of each calendar year.

The FCA had originally proposed that firms should use proxies and assumptions to fill in any gaps and methodological difficulties, but, following feedback to the proposal that the use of proxy data and assumptions could lead to misleading, inconsistent and inaccurate disclosure, defeating the purpose the disclosures were intended to serve, the FCA has clarified that data gaps and methodological challenges should only be filled by proxies or assumptions where it is appropriate to use proxies and assumptions, and should not be used where this would lead to misleading disclosures.[16] Reports must contain adequate explanation of any gaps in data and how those gaps have been filled or why they have not been filled.[17]

Manager Reports

A firm must include in its Manager Report climate-related financial disclosures regarding the overall assets managed or administered by the firm in relation to its in-scope business.[18] The firm must explain (or cross-reference to the particular Product Report) where its approach to a particular investment strategy is materially different to its overall firm-level approach to governance, strategy or risk management under the TCFD Recommendations and Recommended Disclosures.[19] The firm must also explain in the Manager Report how its strategy under the TCFD Recommendations and Recommended Disclosures has influenced its decision making and its delegation of services/use of third parties.[20] Where a firm is headquartered in or operates in a country which has made a commitment to a net zero economy,[21] firms are encouraged to assess the extent to which it has considered that commitment in developing and disclosing its transition plan, or explain why it has not done so.

The new provisions then provide additional rules and guidance on how to complete a Manager Report in a manner consistent with the TCFD Recommendations and Recommended Disclosure, particularly providing extra explanations on how the FCA expects firms to complete the sections of the report dealing with:

- Climate-related scenario analysis.
- Targets and Key Performance Indicators.
- Disclosures contained in other Reports, including of group entities and Product Reports.

A Manager Report must contain a statement, signed by a member of the firm's senior management, confirming that the disclosures in the Report, including any third party or group disclosures cross-referenced in it, comply with the requirements under ESG 2.

Product Reports

As stated above, Product Reports must be published by 30 June of each year, and they must then be cross-referred to in at least one client-facing report (such as an annual or half-yearly report or a periodic client report) which most closely follows 30 June.[22] In preparing a Product Report, a firm must select from within the 12-month reporting period, the most recent calculation date for which up to date information is available.[23]

In a Product Report, firms must include information for each in-scope product according to the following metrics, using the calculations contained in the TCFD Annex and having regard to the TCFD's Guidance on Metrics, Targets and Transition Plans: Scope 1 and

12 https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf.
13 https://assets.bbhub.io/company/sites/60/2020/10/FINAL-TCFD-Annex-Amended-121517.pdf.
14 For example, the TCFD Final Report, TCFD Technical Supplement, TCFD Guidance on Risk Management Integration and Disclosure, and the TCFD Guidance on Metrics, Targets and Transition Plans.
15 ESG 2.1.3 R.
16 ESG 2.1.10 R.
17 ESG 2.1.12 R.
18 ESG 2.2.1 R (1).
19 ESG 2.2.1 R (2).
20 ESG 2.2.1 R (3).
21 Including the UK, under the Climate Change Act 2008 (2050 Target Amendment) Order 2019.
22 ESG 2.3.1 R.
23 ESG 2.1.9 R.

2 greenhouse gas emissions; Scope 3 greenhouse gas emissions; total carbon emissions; total carbon footprint; and weighted average carbon intensity.[24]

The Product Report must also include relevant contextual information, historical annual calculations (after the first year of preparing a Product Report), and any disclosures under the Governance, Strategy and Risk Management recommendations where the approach is materially different to the firm-level approach.[25]

Firms must include in the Product Report:

- A qualitative summary of how climate change is likely to impact the assets underlying the relevant product under the "orderly transition,"[26] "disorderly transition"[27] and "hothouse world"[28] scenarios.
- A discussion of the most significant drivers of impact on that product.[29]

Where the product in question has concentrated exposures or high exposures to carbon intensive sectors, the firm must also describe these and disclose:

- A quantitative analysis of "orderly transition," "disorderly transition" and "hothouse world" scenarios.[30]

As far as reasonably practicable, firms must also include the calculations for each product showing the climate value-at-risk and metrics that show the climate warming scenario with which the product is aligned, such as using an implied temperature rise metric.[31]

Firms may also include in a Product Report any other metrics which the firm considers an investor would find useful when deciding whether to select a particular product.

24 ESG 2.3.9 R (1).
25 ESG 2.3.9 R (2).
26 Assumes that climate policies are introduced early and gradually become more stringent, reaching net zero CO_2 emissions around 2050 and likely limit global warming to below 2ºC on pre-industrial averages: ESG 2.3.11 R (3)(a).
27 Assumes climate policies are delayed or divergent, requiring sharper emissions reductions achieved at a higher cost and with increased physical risks in order to limit temperature rise to below 2ºC on pre-industrial averages: ESG 2.3.11 R (3)(b).
28 Assumes only currently implemented policies are preserved, current commitments are not met and emissions continue to rise, with high physical risks and severe social and economic disruption and failure to limit temperature rise: ESG 2.3.11 R (3)(c).
29 ESG 2.3.11 R (1)(a) and (b) and (2).
30 ESG 2.3.11 R (1)(c).
31 ESG 2.3.13 R.

On Demand Reports

From 1 July 2023, a client[32] who requires on-demand information in order to satisfy climate-related disclosure obligations is entitled to request and be provided with such information from the firm. In responding to such a request, the firm must provide on-demand information for the most recent calculation date for which up to date information is available, or for such other period as is agreed between the firm and client.[33]

If a client requests additional climate or carbon-related data which is reasonably required to satisfy climate-related financial disclosure obligations—even if it is beyond what would be included in a Product Report—then a firm must provide that data if it is reasonably practicable to do so and permitted under any contractual arrangements governing the firm's use of the data.[34]

Sustainability Related Disclosures (SRD)

In Discussion Paper 21/4,[35] the FCA has set out for discussion certain proposals to extend the required disclosures beyond climate-related disclosures (as set out above) to other ESG disclosures. In the Discussion Paper, this extended disclosure regime is referred to as "Sustainability Related Disclosures" or SRD. The FCA intends to issue a Consultation Paper for formal consultation during 2022 in which draft SRD rules will be included. The FCA also set out its current thinking in relation to ESG labels in the Discussion Paper (see "*UK Sustainable Product Labels*").

As the SRD is presently at an early stage, it is only worth summarising here a few of the salient points.

- Consumer-Facing Disclosures: The FCA currently envisages an "initial layer of disclosures that are more accessible to retail consumers".[36] This would include the investment product label, the objective of the product, the investment strategy pursued to meet the objectives, proportion of assets allocated to sustainable investments, approach to investor stewardship and wider sustainability performance metrics.

32 Including an underlying investor in an unauthorised AIF managed by a UK AIFM which is not listed on a recognised investment exchange: ESG 2.3.5 R (4).
33 ESG 2.3.5 R.
34 ESG 2.3.8 R.
35 https://www.fca.org.uk/publication/discussion/dp21-4.pdf.
36 Discussion Paper, paragraph 4.6.

- Baseline Sustainability Metrics: The FCA is considering prescribing a baseline set of sustainability metrics "to enable consumers to understand the sustainable performance of the product over time, for example carbon reduction metrics", and this could be supplemented by other social and governance metrics.
- Product Level Disclosures: The FCA envisages requiring firms to publish detailed product level disclosures, setting out information on methodologies and the calculation of metrics, including information on data sources, limitations, supporting narratives, contextual and historical information, information about alignment with the UK taxonomy, and information about benchmarking and performance.[37]

37 Discussion Paper, paragraphs 4.14-4.17.

- Manager Level Disclosures: The FCA is considering requiring managers to publish detailed information about how risks and opportunities are incorporated into the investment processes and the impacts firms are having on the environment and society. This would be an expansion of the regime beyond the TCFD-aligned disclosures discussed above to include social and governance features.
- Interaction with EU SFDR and other international requirements: The FCA is considering how to design an SDR regime in a manner which will not require significant additional work or fragmentation for firms subject to the EU SFDR or other comparable international requirements.

The FCA is also considering additional practical changes—for example, how to ensure that information is communicated effectively and efficiently along the investment chain—and whether there is a suitable role for third-party verification and supervision of disclosures.[38]

38 Discussion Paper, Chapter 5.

3. Proposed UK Sustainable Product Labels

The FCA's focus on addressing 'greenwashing' practices has been evident in its public statements and its communications with authorised firms. In July 2021, the FCA published a "Dear Chair" letter to Authorised Fund Managers (AFM) setting out its "guiding principles on design, delivery and disclosure of ESG and sustainable investment funds".[39] In that letter, the FCA expressed its view of what would constitute greenwashing and how to avoid it.

The FCA's Discussion Paper (DP21/4) entitled "Sustainability Disclosure Requirements (SDR) and investment labels"[40] sets out "potential approaches to a sustainable product classification and labelling system".[41] Although expressed to be addressed to AFMs of products marketed to retail consumers, the FCA's observations clearly have broader market significance. In proposing such labels, the FCA is keen to establish "objective criteria" and "common terminology" to "…combat potential greenwashing and enhance trust".

Proposed Scope

The FCA is considering whether the labelling rules should apply only to products which make sustainability claims or which are being marked as sustainable, or to all investment products available to retail customers.

Design Principles

In the Discussion Paper, the FCA sets out three design principles which it currently views as important features of any labelling and classification system.

First, the FCA believes that the labels should be objective and descriptive, rather than subjective—the FCA is keen to avoid a labelling system which calls some investments "good" or "bad," or adopts a "traffic light" approach. Rather, the FCA wants an objective system which can be tested and supervised effectively. Avoiding subjectivity is a key issue in the aim to avoid greenwashing.

39 https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf.
40 https://www.fca.org.uk/publication/discussion/dp21-4.pdf.
41 https://www.fca.org.uk/publication/discussion/dp21-4.pdf, paragraph 3.1.

Second, the FCA thinks that the labelling system should be able to differentiate between investments which have particular objectives and strategies, as opposed to investments which have a particular allocation of sustainable projects and activities. In EU terms, this would appear to be endorsing the importance of being able to classify Article 8 and Article 9 funds distinctly.

Third, the FCA wants the labelling system to be consistent and compatible with the current market. Rather than adopting a completely new vocabulary, the FCA thinks it would be preferable to use terminology that is already familiar, albeit giving such terms greater precision where appropriate, whilst allowing developments in the market.

Current Labels and Standards

The FCA has noted that, at least within the EU if not more widely, the SFDR classifications of Article 6, Article 8 and Article 9 products have become a *de facto* classification and labelling system. The FCA also notes that other labels within the EU have already come into force (such as the French SRI and Greenfin labels), or are being proposed/consulted on (such as the EU Ecofin label and proposals by the German regulator, BaFin[42]). The FCA also explained its view on the overlay of the labels with the SFDR's product categories.

42 Bundesanstalt für Finanzdienstleistungsaufsicht.

The FCA also points to other sustainability disclosure and classification initiatives, such as from the CFA institute, the IA, The Investing and Saving Alliance, the British Standards Institution and IOSCO, and is seeking input on how it could leverage off these initiatives.

Potential Approach

Whilst this remains subject to comments in the Discussion Paper, and subject to further elaboration in an expected Q2 2022 Consultation Paper, the FCA has proposed that there should be five categories of product labels:

- Products not promoted as sustainable.
- "Responsible" products (which may have some sustainable investments).
- "Transitioning" products (which have sustainable characteristics, themes or objectives, and low allocation to Taxonomy-aligned sustainable activities).
- "Aligned" products (which have sustainable characteristics, themes or objectives, and high allocation to Taxonomy-aligned sustainable activities).
- "Impact" products (which have the objective of delivering positive environmental or social impact).

Of these, "Transitioning", "Aligned" and "Impact" products would be viewed as "Sustainable".

Recognising that firms will have already put a great deal of effort into complying with the EU SFDR regime, the FCA notes that these five classes should correspond to familiar EU SFDR concepts: (i) Products not promoted as sustainable would map to Article 6 products; (ii) "Responsible" and "Transitioning" products would map to Article 8 products; and (iii) "Aligned" and "Impact"[43] products would map to Article 9 products.

In giving these labels greater precision and detail, the FCA is seeking feedback on various points, including:

- Whether the "Responsible" and "Sustainable" labels should require firms to demonstrate a baseline of "entry-level criteria" at entity level, applicable to both the product and the firm managing the investments.
- How to define "Impact", in particular whether impact should include enterprise impact, financial impact and non-financial impact; whether impact should include the concepts of intentionality, return expectations and ongoing measurement of impact; and "additionality" (which the FCA says can be defined in terms of whether a proposed activity will produce some 'extra good' in the future relative to a specified baseline).[44]
- In relation to "Aligned" and "Transitioning", proposes that the distinction between these two types of products would be on the basis of the proportion of assets consisted "sustainable" based on the UK taxonomy (or other criteria), with "Transitioning" products having a low allocation to sustainable activities (as defined by the UK Taxonomy or other benchmark), and "Aligned" products having a higher allocation. The FCA suggests that this would allow consumers to "choose whether they want to invest in a product that uses stewardship influence and other means to become more sustainable over time", and therefore invest in "Transitioning" products; or whether they would prefer "to invest in companies already possessing certain sustainable characteristics", and therefore invest in "Aligned" products.[45]
- Regarding "Responsible" products, the FCA suggests that these might be characterised "by the integration of ESG factors and stewardship, directed towards the delivery of long-term sustainable investment factors and returns", and could have an "entity" level criterion (i.e. evidence about effective stewardship at the management level as well).[46]

The FCA is also seeking views on whether any of these labelling considerations should have a bearing on other features of the financial markets, such as benchmarks and indices, derivatives, short-selling and securities lending.

43 The FCA states that "Impact" products would be "a category in [their] own right, comprising only a (small) subset of Article 9 funds": https://www.fca.org.uk/publication/discussion/dp21-4.pdf, paragraph 3.12.

44 https://www.fca.org.uk/publication/discussion/dp21-4.pdf, paragraph 3.25.

45 https://www.fca.org.uk/publication/discussion/dp21-4.pdf, paragraph 3.35.

46 https://www.fca.org.uk/publication/discussion/dp21-4.pdf, paragraph 3.38.

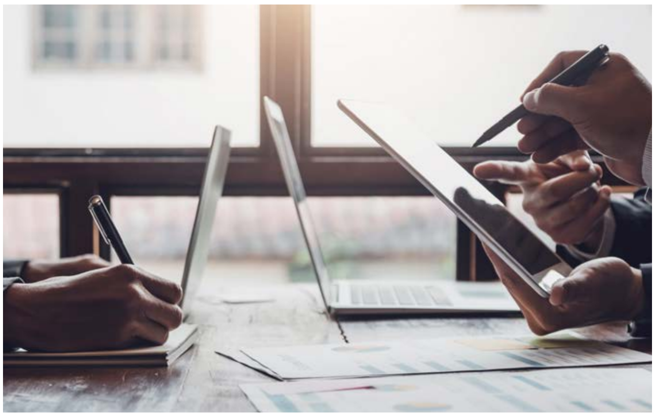
4. New UK Prudential Regime for Investment Firms

On 1 January 2022, the FCA's new Investment Firm Prudential Regime (IFPR) came into effect. The IFPR replaces the previous prudential rules and streamlined the FCA's approach to prudential supervision of investment firms.

In place of the prior different prudential categories of investment (for example, Exempt CAD, BIPRU and IFPRU firms), the IFPR introduced a single category of 'MIFIDPRU investment firms'. Some of the largest, most interconnected investment firms (i.e. those that are dual-regulated by the FCA and the PRA) will continue to fall under the prudential rules designed for banks set out in the UK Capital Requirements Regulation, but all FCA solo-regulated investment firms carrying out MiFID business and Collective Portfolio Management Investment Firms (CPMIs) are now MIFIDPRU investment firms.

In addition to imposing obligations on investment firms themselves, the new rules include requirements on regulated and unregulated holding companies of groups that contain such investment firms (including requirements to hold regulatory capital). The IFPR regime can now be found in the new MIFIDPRU Sourcebook of the FCA Handbook.[47]

Although the new regulatory capital requirements are now met (at least on a transitional basis), the IFPR has more challenges in store. Implementation challenges for 2022 include tackling the new ICARA process, incorporating the new remuneration requirements, and collecting data and preparing new reports and disclosures.



Risk Management and ICARA

There are different levels of risk management for non-SNI firms, depending on the size of the firm. Risk, remuneration and nomination committee requirements do not apply to non-SNI firms which have on- and off- balance sheet assets over the preceding four year period were a rolling average of £100 million or less or, alternatively, if they were a rolling average of £300 million or less and the exposure value of the firm's balance sheet trading book business is £150 million or less and the exposure value of the firm's balance sheet derivatives business is £100 million or less (large Non-SNI firms). These amounts must be calculated on an individual basis.

All MIFIDPRU investment firms must comply with the internal governance requirements set out in MIFIDPRU 7.2, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks the firm is or the firm poses or might pose to others, and adequate internal control mechanisms, including sound administration and accounting procedures. These requirements dovetail with governance requirements already required under SYSC.

All MIFIDPRU investment firms are required to comply with the baseline obligations under the ICARA process (which replaces ICAAP), which is designed to ensure that such firms have appropriate systems and controls in place to identify, monitor and, where proportionate,

47 https://www.handbook.fca.org.uk/handbook/MIFIDPRU.pdf.

reduce all potential material harms that may result from the ongoing operation of its business or winding down of its business and hold financial resources that are adequate for the business it undertakes.

The overall financial adequacy rule requires firms, at all times, to hold own funds and liquid assets which are adequate, both as to amount and quality, to ensure that the firm is able to remain financially viable throughout the economic cycle, with the ability to address any material potential harm[48] that may result from its ongoing activities and that the firm can be wound down in an orderly manner, minimising harm to consumers or other market participants.[49]

The ICARA process is an internal process designed to ensure that the firm complies with the overall financial adequacy rule. It includes:

- Capital and liquidity planning, stress testing, wind-down planning and recovery planning;
- Assessing and monitoring the adequacy of own funds;
- Assessing and monitoring the adequacy of liquid assets; and
- Carrying out a periodic review of the firm's ICARA process and record-keeping.

Although investment firms that are part of a group will need to consider group risk as part of their individual ICARA process, investment firms are only required to carry out the ICARA process on a consolidated basis in exceptional circumstances.[50]

Disclosures and Reporting

Firms will need to consider their regulatory reporting requirements under MIFIDPRU 9, which includes, for all MIFIDPRU investment firms, quarterly reporting of capital, liquidity and metrics monitoring and an annual ICARA assessment questionnaire.[51] Non-SNI firms have additional concentration risk reporting requirements on a quarterly basis. Investment firm groups subject to prudential consolidation are required to report on a consolidated basis. Investment firms applying the group capital test are required to carry out group capital test reporting on a quarterly basis. Additional reporting requirements apply under the MIFIDPRU Remuneration Code, which are covered below.

48 MIFIDPRU 7, Annex 1 contains guidance on assessing potential harms
49 MIFIDPRU 7.4.7 R.
50 MIFIDPRU 7.9.4 G.
51 MIFIDPRU 9.2.

Before the introduction of the IFPR regime, CPMI firms filed an additional return FIN067, and this continues to be the case. However, the information required to be submitted will be simplified, and, for example, it will no longer be required to submit granular information on PII policies held by CPMI firms.

Public disclosures are required on an individual basis by MIFIDPRU investment firms under MIFIDPRU 8. These are required, at a minimum, to be updated annually on the date that the firm publishes its annual financial statements or, where it does not publish annual financial statements, the date on which its annual solvency statement is submitted to the FCA in accordance with SUP 16.12. More regular disclosures should be made if appropriate (for example, in the event of a major change in business model or a merger has taken place). For example, if a firm's accounting reference date is 31 December and is, therefore, required to publish their accounts by 30 September of the following year. The first set of MIFIDPRU disclosures will apply to the period ending on 31 December 2022 and will need to be published by 30 September 2023.

Disclosures apply in the following areas:

- Governance arrangements – applies to non-SNI MIFIDPRU investment firms.
- Own funds – applies to non-SNI MIFIDPRU investment firms, as well as SNI MIFIDPRU investment firms that have additional tier 1 instruments in issue.
- Own funds requirements – applies to non-SNI MIFIDPRU investment firms, as well as SNI MIFIDPRU investment firms that have additional tier 1 instruments in issue.
- Remuneration policy and practices – applies to all MIFIDPRU investment firms.
- Risk management objectives and policies – non-SNI MIFIDPRU investment firms, as well as SNI MIFIDPRU investment firms that have additional tier 1 instruments in issue.
- Investment Policy – only applies to large non-SNI firms.

Transitional provisions apply to the disclosure requirements. If a firm has an accounting reference date on or before 30 December 2022, the 2022 disclosures required under MIFIDPRU 8 do not need to include the requirements relating to risk management objectives and policies or the firm's investment policy. This information will need to be included in the following year's disclosures.

Transitional provisions also apply to remuneration disclosures relating to a performance period that began before and ends after 1 January 2022. If the firm is currently subject to disclosures under BIPRU 11.5.18 R to 11.5.20 R or article 450 UK CRR, then it should publish the remuneration information it would have been required to publish under those provisions as if they had remained in place for the full performance period. For the following performance period, the remuneration disclosures required under MIFIDPRU 8 should be published.

MIFIDPRU Remuneration Code

A new MIFIDPRU Remuneration Code has been introduced as part of the IFPR, and is set out in SYSC 19G in the FCA's Senior Manager Arrangements, Systems and Controls (SYSC) sourcebook. The MIFIDPRU Remuneration Code applies in its entirety to Large Non-SNI firms (the "Extended Remuneration Requirements"). There are some carve-outs for other non-SNI firms (the "Standard Remuneration Requirements") and only the most basic provisions will apply to SNI firms (the "Basic Remuneration Requirements").

When assessing whether a CPMI firm is a Large Non-SNI firm, the thresholds must be assessed on the total of its MiFID and non-MiFID business.

Where a firm is subject to more than one remuneration code (for example, the AIFM Remuneration Code), then it must comply with the most stringent of the relevant provisions.

The general requirements of the MIFIDPRU Remuneration Code cover all aspects of remuneration (including carried interest) and cover all staff (including employees of the firm, partners or members, employees of other entities in the group, employees of joint service companies and secondees).

Where the group capital test is applied, the MIFIDPRU Remuneration Code is applied on an individual basis. Where consolidation applies, the MIFIDPRU Remuneration Code will apply to the UK parent entity on a consolidated basis. A UK parent entity will need to consider whether it should be treated for the purposes of the MIFIDPRU Remuneration Code as an SNI firm, or a non-SNI firm. The Large Non-SNI firm rules under the Extended Remuneration Requirements will not apply to a UK parent entity on a consolidated basis.

The FCA has published templates for Remuneration Policy Statements for use by investment firms to record how their policies and practices comply with the MIFIDPRU Remuneration Code, including a table for Material Risk Takers (MRTs).[52]

Some of the main requirements under the MIFIDPRU Remuneration Code are set out below:

Basic Remuneration Requirements

- The firm's remuneration policies and practices must be proportionate to the risks inherent in the firm's business model, to be gender neutral, to be consistent with, and promote, sound and effective risk management, to be in line with business strategy, objectives and the long-term interests of the firm and contain measures to avoid conflicts of interest.
- The remuneration policies and practices must be subject to management body oversight.
- Staff engaged in control functions must be independent from the business units that they oversee, have appropriate authority and be remunerated in accordance with the achievement of the objectives linked to their function, independent of the performance of the business areas they control.
- All remuneration paid to staff must be clearly categorised as fixed or variable, with fixed remuneration primarily reflecting professional experience and organisational responsibility, and variable remuneration (including discretionary pension benefits) should be based on performance or, in exceptional circumstances, other conditions.
- Variable remuneration based on individual performance must take into account financial as well as non-financial criteria.
- MIFIDPRU investment firms must ensure that variable remuneration does not affect the firm's ability to ensure a sound capital base.

Standard Remuneration Requirements

- Non-SNI firms are required to set an appropriate ratio between the variable component and the fixed component of total remuneration in their remuneration policies. Different ratios may apply to different categories of staff. When setting

52 These are available on the FCA's IFPR landing page, https://www.fca.org.uk/firms/investment-firms-prudential-regime-ifpr.

the ratio, the firm should consider all potential scenarios, including that the firm exceeds its financial objectives and should reflect the highest amount of variable remuneration that can be awarded in the most positive scenario.

- Non-SNI firms must, at least annually, conduct a review of remuneration policies and practices.
- Where variable remuneration is performance-related, the total amount of variable remuneration must be based on a combination of the performance of the individual, the business unit and the overall results of the firm. The assessment must be done on a multi-year framework.
- Non-SNI firms must assess, at least annually, which of its staff are material risk-takers (MRTs). A list of criteria by which staff would be categorised as a MRT is set out in SYSC 19G.5.3. The definition of MRT has not substantially changed but there are some additions and minor amendments. Where consolidation applies, MRTs must be identified at individual level and at a consolidated level.
- Non-SNI firms must ensure that all guaranteed variable remuneration, retention awards, severance pay and buy-out awards are subject to malus and clawback.
- Guaranteed variable remuneration, retention awards, severance pay and buy-out awards are only permitted to be awarded in limited circumstances and only to MRTs.
- Non-SNI firms are required to ensure that measurements of performance used as a basis to calculate pools of variable remuneration take into account current and future risks and must ensure that total variable remuneration is considerably reduced where the financial performance of the firm is subdued or negative, including through the use of malus or clawback arrangements.
- Deferred portions of variable remuneration must only be paid if sustainable according to the financial situation of the firm as a whole, and justified on the basis of the performance of the firm, the business units and the individual concerned.
- Non-SNI firms must ensure that all of the total variable remuneration is subject to in-year adjustments, malus or clawback arrangements, particularly covering situations where the individual is a MRT and was responsible for conduct which resulted in significant losses and/or failed to meet appropriate standards of fitness and propriety.
- Non-SNI firms must set minimum malus and clawback periods as part of its remuneration policies and ensure that malus can be applied until the award has vested in its entirety. Clawback periods must span at least the combined length of deferred and retention periods.
- Non-SNI firms must ensure that any discretionary pension benefits it awards or pays to MRTs are in line with business strategy, objectives, values and long-term interests. Malus and clawback should apply in the same way as to other elements of variable remuneration.

Extended Remuneration Requirements

- Additional requirements apply to the remuneration of MRTs in Large Non-SNI firms unless the MRT's variable remuneration does not exceed £167,000 and does not represent more than one-third of their total annual remuneration. The additional requirements include:
  - At least 50 per cent of the variable remuneration paid to a MRT in relation to a performance period consist of 'eligible instruments'.
  - Eligible instruments must be subject to an appropriate retention policy, taking into consideration the length of any deferral period, the length of the firm's business cycle, the types of risks relevant to the role of the staff member and how long it could take for the risks underlying the staff member's performance to crystallise.
  - Variable remuneration components must not be awarded or paid unless at least 40 per cent is deferred over a period of at least three years. Where the variable remuneration is particularly high (including all such remuneration of £500,000 or more), at least 60 per cent must be deferred. The first deferred portion must not vest earlier than a year after the start of the deferral period and must vest no faster than on a pro rata basis.

5. AIFMD Review

The European Commission finally published its proposed amendments to Directive 2011/61/EU (AIFMD) in November 2021, following certain suggestions by the European Securities and Markets Authority (ESMA). Similar changes are also proposed to be applied to Directive 2009/65/EC ("UCITS Directive").[53]

The Commission's key proposals are in the following areas:

- Delegation arrangements
- Liquidity risk management
- Depositaries
- Loan originating AIFs
- Restriction on marketing AIFs based in "non-cooperative jurisdictions".

Delegation

Despite some fears that the Commission would use the opportunity provided by the review to impose much stricter requirements around delegation, the proposed changes are not as material as were feared.

- The Commission have formalised a basic substance requirement requiring AIFMs to employ at least two persons full-time (or engage two persons who are not employed by the AIFM but are committed to conduct the AIFM's business on a full time basis) who are resident in the EU.
- The delegation provisions in Article 20 AIFMD are extended to apply to all of the functions listed in Annex 1 and the ancillary services in Article 6(4) (as amended).
- The Annex 1 functions are extended to include originating loans and "servicing securitisation special purpose entities"
- The ancillary activities an AIFM may perform under Article 6(4) – currently portfolio management, investment advice, limited safe-keeping administration activities and reception and transmission of orders - have been broadened to include administration of benchmarks and credit servicing in accordance with the relevant EU legislation.

Delegation will be more closely monitored as ESMA will receive annual notifications from the EU national regulators if an AIFM delegates more portfolio management or risk management functions to third country entities than it retains. ESMA will report to the European Parliament, Council and Commission every two years on market practice in relation to delegation to entities in third countries.

Liquidity Risk Management

The proposal sets out a requirement for open-ended AIFs to select at least one appropriate liquidity management tool from a list set out in a new Annex V, which includes redemption gates, notice periods, redemption fees, swing pricing, an anti-dilution levy, redemptions in kind and side pockets. The new

53 The proposal is available here: https://assets.contentstack.io/v3/assets/blt3de4d56151f717f2/bltb5dc2704a4334063/COM(2021)721_0_(1).pdf, and the annexes are available here: https://assets.contentstack.io/v3/assets/blt3de4d56151f717f2/bltd580c373817e8989/619f8553e91e152183d8515c/Annex.pdf.

liquidity management tools included in Annex V are additional to the existing tools such as the suspension of redemption rights. The AIFM must put in place policies and procedures for activation, deactivation and operation of such tools. Temporary suspensions or redemption/repurchase rights should only be triggered in exceptional cases where justified in the interests of AIF investors.

The proposals include a new power granted to competent authorities to require AIFMs to activate or deactivate the relevant liquidity management tools. This new power would extend also to non-EU AIFMs that are marketing AIFs that they manage.

Depositaries

Whereas currently, EU AIFs are only permitted to appoint a depositary located in the same Member State, the proposal permits competent authorities to allow cross-border depositary services pending a review to be carried out into the possibility of creating a depositary passport at EU level. Article 21(16) is also amended to require depositaries to cooperate not only with their own competent authority but the competent authority of the AIF that has appointed it as depositary and of the AIFM that manages that AIF.

Central Securities Depositaries (CSDs) have also been recognised in the custody chain, but the new proposals acknowledge that a CSD shall not be considered a delegate of the depositary and confirm a depositary is not required to carry out due diligence on a CSD.

Loan-Originating AIFs

The proposals introduce a number of rules applicable to AIFMs managing loan originating funds, including the following:

- Where the notional value of an AIF's originated loans exceeds 60 per cent of its net asset value, the AIF will be required to be closed-ended.
- AIFs will be required to retain, on an ongoing basis, an economic interest of 5 per cent of the notional value of loans originated and subsequently sold on the secondary market.
- Restrictions on loan originating AIFs from lending to the AIFM or its employees, its depositary or entities to which functions have been delegated.
- Concentration limits on lending to financial institutions, such that loans to a single borrower do not exceed 20 per cent of the AIF's assets.

Restrictions on Marketing

The proposal includes a requirement that third country AIFs should only be permitted to be marketed in the EU if their home state is not identified as a high risk third country under the Anti-Money Laundering Directive[54] or a non-cooperative jurisdiction for tax purposes, as determined by the EU Council.[55]

Currently, the restriction relates to the Financial Action Task Force blacklist on Non-Cooperative Countries and Territories, the proposed restriction. However, the change could be significant for offshore funds, as in recent years, the EU list of non-cooperative jurisdictions has included the Cayman Islands and the EU continues to show interest in offshore financial centres. As jurisdictions may added to the list of non-cooperative jurisdictions at short notice, this could have a potentially material impact on the ability of funds established in off-shore centres to access the EU investor base.

Next Steps

The Commission's proposal must now be considered by the EU Parliament and Council and may be subject to further amendments, followed by a proposed two year implementation period. Some areas also provide for secondary legislation to set out in greater detail the requirements, for example, defining liquidity management tools, which will be developed by ESMA. The rules are, therefore, not likely to come into force before 2024 -2025.

54 Article 9(2) of Directive (EU) 2015/849
55 Annex I to the Council conclusions of 2020 on the revised EU list on non-cooperative jurisdictions for tax purposes

6. Changes to EU and UK Short Selling Regulations

The European Commission have revised the EU Short Selling Regulation[56] ("EU SSR") to permanently lower the initial net short position reporting threshold from 0.2 per cent to 0.1 per cent in respect of positions in shares of an issuer admitted to trading on an EU trading venue unless the shares are excluded.[57] The change will take effect on 31 January 2022. This change is consistent with the threshold set in the UK, which was permanently lowered to 0.1 per cent in February 2021.

In addition, ESMA is consulting[58] on a number of other changes to the EU SSR, following its review of the impact of the COVID-19 pandemic and recent developments relating to so-called 'meme stocks' such as GameStop. The key measures ESMA are consulting on are as follows:

- Clarification that the relevant competent authority (RCA) for imposing emergency measures (such as short selling bans under Article 20 EU SSR) is the RCA that has competency with respect to the financial instrument underlying any derivatives, even if those derivatives are admitted to trading on a regulated market otherwise under the competency of another regulator.
- Changing the procedure for imposing short term short selling bans under Article 23 EU SSR so that the RCA of the most relevant market for an instrument may impose a single ban across all Member States and amending the scope of Article 23 bans to include entering into or increasing net short positions rather than just short selling transactions.
- Excluding indices, baskets and ETFs from the scope of long term short selling bans; or alternatively introducing a percentage-based weighting approach.
- Amending the circumstances in which ESMA may take emergency measures under Article 24 EU SSR.
- Amending the 'locate' arrangements for covered short selling so that third parties providing locate arrangements are required to provide a commitment to make the shares available for settlement in due time and proposing a single uniform locate arrangement based on the current 'standard same day locate arrangement' requirements.
- Requiring parties entering into short sales to maintain records of their arrangements for five years.
- Establishing a minimum sanction for infringement of the naked short selling prohibition.
- Amending the criteria for inclusion of shares on the "Exempted Shares" list so that shares with a significant percentage of trading within the EU would not be exempt even if the most relevant market for liquidity is outside of the EU.
- Proposing centralised publication of aggregated net short positions per issuer.
- Implementing a single, centralised EU-wide notification and publication system for net short positions.

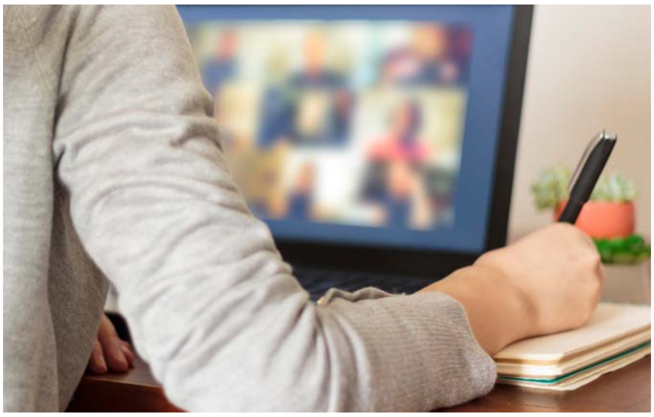
In addition, ESMA have proposed a further consultation about the possibility of including subscription rights within the scope of net short position disclosures. ESMA will consider the feedback it receives and expects to publish a final report to the EU Commission in early 2022.

56 Regulation (EU) No. 236/2012.
57 ESMA maintains a list of "Exempted Shares" that are excluded from the scope of the EU SSR for shares whose principal liquidity is located on a venue outside of the EU.

58 ESMA Consultation Paper – Review of certain aspects of the Short Selling Regulation, 21 September 2021, https://www.esma.europa.eu/sites/default/files/library/esma70-156-3914_consultation_paper_on_the_review_of_certain_aspects_of_the_short_selling_regulation.pdf.

7. Market Abuse – Continued Focus on Remote Working and Surveillance of Market Conduct

Preventing, detecting and punishing market abuse continues to be a priority for the FCA – this is clear from the public statements made by the FCA in 2021. Two broad key themes may be observed in the FCA's guidance and commentary on market abuse: ensuring that firms are prepared for the longer-term transition to hybrid "office/home" working, or fully working from home; and increased market surveillance.



Transition to Hybrid Working and Working from Home

Some financial services firms have already returned to working from the office full time (subject to any further changes to government guidance or rules), and others intend to do so. Other firms, however, are adopting a hybrid approach of allowing some or all personnel to work from home at least some of the time or – in a minority of cases – all of the time.

In October 2021, the FCA set out a specific set of "remote or hybrid working expectations for firms",[59] which emphasises the importance of firms' having carefully considered what their working arrangements will look like going forward, and having planned how they will ensure their regulatory obligations are met under those arrangements. In particular, the FCA reminded firms that there may be a need to inform the FCA if their working arrangements have changed. This will include updating internal policies and procedures, ensuring that IT and any data, cyber and security risks have been considered, and the effects on staff (including wellbeing, training and diversity and inclusion) have been appropriately taken into account.

At the same time, the FCA also noted its power to "visit any location where work is performed, business is carried out and employees are based", whether as part of the FCA's supervisory or enforcement work. The FCA advised firms to make sure that their employees knew that this could extend to their home addresses.

The FCA has reiterated to firms the importance of monitoring individuals' communications, especially when they are away from the more controlled environment of an office.[60] The FCA has, not for the first time, taken particular care to warn firms about the dangers of individuals using "unmonitored and/or encrypted communication applications (apps) such as WhatsApp".[61]

Whilst the FCA has stopped short of saying that individuals must not use WhatsApp or similar communication methods, the FCA has noted that it has taken action against individuals and firms relating to the use of WhatsApp and other social media platforms, and firms should have policies and procedures in place surrounding the use of such communications technology which are reviewed regularly "every time the context and environment they operate in changes", and to provide training when appropriate.[62] This is particularly true when firms are under an obligation to ensure that communications are recorded. Interestingly, US regulators have also recently brought actions against firms in relation to use of WhatsApp by personnel.[63]

59 "Remote or hybrid working expectations for firms", 11 October 2021, https://www.fca.org.uk/firms/remote-hybrid-working-expectations.

60 See Market Watch 66, https://www.fca.org.uk/publications/newsletters/market-watch-66.

61 See Market Watch 66, https://www.fca.org.uk/publications/newsletters/market-watch-66.

62 See Market Watch 66, https://www.fca.org.uk/publications/newsletters/market-watch-66.

63 See, for example, https://www.sec.gov/news/press-release/2021-262.

The FCA's Market Surveillance

The FCA has sophisticated methods of monitoring the market for potentially abusive trading, including reviewing trading around the time of a major announcement, such as immediately prior to a takeover.

Based on its observations of relevant data, the FCA publishes a "Market Cleanliness metric" or "MC metric", which is intended to be a "proxy for insider dealing in the market, or, at least, the amount of insider dealing that *might* be occurring in the market ahead of takeovers".[64]

Given certain limitations in the MC metric, however – including the small sample size – the FCA has been developing new metrics which can be used alongside it. Over the last few years, the FCA has developed two new metrics: the Abnormal Trading Volume (ATV) and the Potentially Anomalous Trading Ratio (PATR).

The former looks for "abnormal increases in trading volumes ahead of potentially price sensitive announcements, covering equity instruments and some equity derivatives", and as such appears to be predominantly quantitative.[65] The PATR, by contrast, appears to be both qualitative and quantitative, as it combines data on trading which occurs ahead of a price sensitive news announcement, as well as qualitative trading data: whether the particular market participant typically trades in the instrument, whether the trade moved in the direction of the announcement, and whether that market participant made a "significant profit" from trading positions established in the period immediately prior to the announcement.

This evidences the FCA's continued investment in ever more sophisticated methods for identifying potentially abusive behaviour.

The Market Abuse Regulation – Updates

As noted above, at the end of the Brexit Transition Period on 31 December 2020, Regulation (EU) No 596/2014 ("EU MAR") ceased to have effect in the UK, and a "retained" version of the law took its place in the UK, commonly known as "UK MAR".

Following a process of divergence and then re-convergence during 2021, the texts of UK MAR and EU MAR remain functionally similar. The changes which were ultimately made to both texts during the course of 2021 were generally administrative, most notably changing the time period in which notifications must be made regarding transactions made by persons discharging managerial responsibilities (PDMRs).[66] One continuing divergence of note relates to certain provisions which apply in EU MAR to financial instruments only traded on SME growth markets.[67]

EU MAR and UK MAR remain very similar regimes. Perhaps the most important difference is their geographic scope:

- EU MAR applies to (i) securities admitted to trading in the European Economic Area (EEA),[68] (ii) securities for which an application for admission to trading in the EU has been made, or (iii) other securities, the value of which depends on or has an effect on the price or value of a security mentioned in (i) or (ii).
- UK MAR applies to (i) securities admitted to trading in the UK, the EU or Gibraltar; (ii) securities for which an application for admission to trading in the UK, the EU or Gibraltar has been made; or (iii) other securities, the value of which depends on or has an effect on the price or value of a security mentioned in (i) or (ii).

Firms should continue to be aware that with the EU MAR and UK MAR regimes now being separate, it may now be necessary to make notifications to more than one regulator (for example, in relation to delayed disclosure of inside information or regarding PDMRs' transactions).

The UK Criminal Regime – Update

The main change in the UK criminal regime this year has been the extension of the potential period of imprisonment from seven years to 10 years for the main UK criminal offences of insider dealing,[69] making misleading statements, creating a false or misleading impressions and making misleading statements in relation to benchmarks.[70]

64 Speech by Mark Steward, Executive Director of Enforcement and Market Oversight, 6 February 2020, https://www.fca.org.uk/news/speeches/market-integrity-and-strategic-approach.

65 Market Cleanliness Statistics, 2020-2021, https://www.fca.org.uk/data/market-cleanliness-statistics-2020-21.

66 There was also a clarification that persons acting on behalf of an issuer must keep their own insider lists.

67 These SME growth market rules particularly affect Article 13 (Accepted market practices), Article 17 (Public disclosure of inside information) and Article 18 (Insider lists).

68 Being the EU Member States, Norway, Liechtenstein and Iceland. EU MAR applied in the EEA from 1 January 2021, after the constitutional notifications process had been completed in accordance with Article 103(1) of the EEA Agreement: see https://www.efta.int/sites/default/files/documents/legal-texts/eea/other-legal-documents/list-of-constitutional-requirements/list-of-constitutional-requirements.pdf.

69 Under Part V of the Criminal Justice Act 1993.

70 Each under Part 7 of the Financial Services Act 2012.

There continues to be a steady number of prosecutions for market abuse offences, and the FCA is currently pursuing several prosecutions, including two brothers, both of whom were fairly junior at the time of the alleged offending, one of whom was an analyst at a major financial institution and the other who was a solicitor at Clifford Chance.

Summary

Given the FCA's consistent stated priority of deterring, detecting and bringing enforcement actions in cases of poor market conduct, firms should ensure that their systems and controls relating to market abuse are appropriate and regularly reviewed. The increase in criminal penalties only amplifies this further.

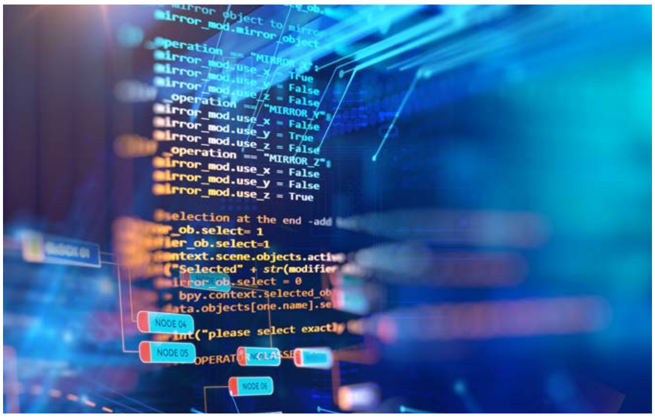
In considering a firm's systems and controls, particular attention should be paid to how the firm has adapted to allowing or encouraging individuals to work from home some or all of the time – whether this is a long term aim of the business, or even if it is simply in response to the ever changing government guidance and advice. Ensuring that policies are in place and followed in relation to the use of private mobile phones and other technology, and especially in relation to communications software such as WhatsApp, is also critical, as it is clear that the FCA is focused on this, and it appears will treat any use of such messaging technology with suspicion.

8. Enforcement Statistics: A Comparison of FCA and SEC Enforcement Activity

The SEC's Enforcement Results for Fiscal Year (FY) 2021[71] (the "Report") indicates at a high level that the SEC remained the more active regulator, bringing more actions than the FCA, and imposing larger fines. That said, the SEC filed a marginally lower total number of cases in FY 2021 (697 total enforcement actions), compared to the previous year (715 enforcement actions). The number of new or 'standalone' cases (i.e. not follow-on administrative procedures or delinquent filings) saw a 7 per cent increase with 434 actions in FY 2021 as compared with 405 in FY 2020.

On the other hand, the number of cases resolved by the FCA (whether by taking action or deciding against doing so) has remained steady.[72] 186 cases closed in 2020/21, 185 in 2019/20 and 189 in 2018/19.

The SEC imposed an increased quantum of financial penalties in FY 2021, obtaining orders requiring the payment of approximately $1.4 billion in financial penalties (compared to approximately $1.1 billion in FY 2020), but a decreased amount of disgorgement, at $2.4 billion, compared to the previous year's new high (approximately $3.6 billion). By contrast, the FCA saw a moderate decrease in the quantum of financial penalties imposed (approximately £190 million in 10 separate cases; eight against firms, and two against individuals) when compared against approximately £224 million in relation to 15 separate cases in 2019/20; 12 against firms, and three against individuals.



Enforcement Areas of Focus

The Report indicates that the SEC has brought numerous enforcement cases across new areas, including a number of 'first of their kind' actions in, among others, the 'dark web' and 'decentralised finance' areas in the securities market. Indeed, there was a significant increase in the number of cases filed in relation to securities offerings; from 130 in 2020, to 150 in FY 2021.[73] The SEC's Chair, Gary Gensler, stated that the SEC's Enforcement Division was "the cop on the beat for America's securities laws" and moreover that the SEC will "go after misconduct wherever [they] find it".[74]

Overall, there was a notable increase in actions filed against investment advisers/investment companies, which almost doubled from 87 actions in FY 2020 to 159 actions in FY 2021. There was an increase in market manipulation cases (from 22 in 2020 to 31 in 2021), with insider trading cases remaining fairly steady (28 in 2021 compared with 33 in 2020). Most notably, the SEC had a record year for whistleblower awards in FY 2021, awarding a total of $564 million to 108 whistleblowers. This resulted in the SEC's whistleblower programme surpassing $1 billion in awards over its life. However, there was a further drop in cases filed under the Foreign Corrupt Practices Act (from 10 in 2020 to 5 in 2021).[75]

71 https://www.sec.gov/news/press-release/2021-238.
72 https://www.fca.org.uk/data/enforcement-data-annual-report-2020-21.
73 https://www.sec.gov/files/2021-238-addendum.pdf.
74 https://www.sec.gov/news/press-release/2021-238.
75 https://www.sec.gov/files/2021-238-addendum.pdf.

The FCA has had a significant number of 'net closures' in cases involving allegations of: (i) insider dealing (of the 87 cases open at the beginning of the year 48 were closed and 33 new investigations were opened); (ii) market manipulation (of the 29 cases open at the beginning of the year 15 were closed and three new investigations were opened); and (iii) financial crime (of the 71 cases open at the beginning of the year 21 were closed and four new investigations were opened). The only significant 'net opening' in case numbers is in relation to cases involving allegations of unauthorised business (seven cases closed, 41 opened). The FCA has closed or not filed as many 'market conduct' cases this year.[76]

Enforcement and the Pandemic

It should be noted that the downturn in figures for the FCA could appear artificially low on account of the pandemic, particularly as the FCA's report covered March 2020 – March 2021, meaning effectively all of its data is from periods when the UK was under differing levels of restrictions due to the coronavirus. The FCA's failure to close as many 'market conduct' cases this year is particularly notable given the general concern at the start of the pandemic that working from home would allow individuals greater opportunity to engage in behaviour constituting market abuse or insider trading, once they were outside of the office. Whilst it remains possible that these cases have yet to be brought, early indications might suggest that the level of concern was unfounded, or perhaps misplaced, and the ability for firms to monitor personnel working remotely was greater than might have been expected.

By contrast, the SEC's Report covers FY 2021, which runs from 1 October 2020 to 30 September 2021, meaning a lot of its data has dissimilarly come from periods where the US started experiencing relief from pandemic-related restrictions and lockdown periods. With regard to FY 2021, the SEC's enforcement director, Gurbir Grewal, stated: "Undeterred by the challenges of the pandemic, the dedicated public servants in the Enforcement Division have continued to overcome obstacles to bring these cases that protect investors and promote market integrity."[77]

76 https://www.fca.org.uk/data/enforcement-data-annual-report-2020-21.

77 https://www.sec.gov/news/press-release/2021-238.

Case Costs and Duration

The FCA's average cost per case to get resolved by agreement (i.e. not pursued in the Regulatory Decisions Committee (RDC) or the Upper Tribunal) is £265,000, whereas the FCA's average cost on a disputed case (i.e. a case that goes through to the Upper Tribunal) is over £800,000. The average case resolved by agreement with the FCA now takes 32.6 months (down from 37.4 months in 2019/20) and the average case referred to the RDC takes 47.2 months (down from 53.5 months in 2019/20). The FCA's statistics indicate an improvement in the average length of time it is taking for resolution of cases, both contested and settled.

For FY 2020, the median time taken by the SEC to complete investigations was 34 months (down from 37 months), and the median time taken to file an action was 21.6 months (the fastest in five years). The SEC does not appear to have reports its investigation costs or duration for FY 2021, which could lead to speculation that they have been unable to deliver on their aim of accelerating the pace of investigations and recommend enforcement actions.[78]

What Can Be Expected in 2022?

Notwithstanding the pandemic, both the SEC and the FCA have clearly remained active. Even if there has been a reduction in the number of cases brought by the FCA, these can be expected to rebound as the world has begun to move past the initial shocks of the pandemic. Given that the pandemic is likely to have pushed back the resolution of cases, and potentially delayed the opening of investigations, the expectation is that the results for both regulators in 2021/2022 (and likely for the next few years, given that most investigations are multiyear affairs) will be higher. Certainly, the SEC's enforcement results show that their new leadership of Chairman Gary Gensler and Enforcement Chief Gurbir Grewal, have followed through on statements in the last FY that the agency planned to step up its enforcement regime and take a more aggressive approach.

78 https://www.sec.gov/files/enforcement-annual-report-2020.pdf, page 10

9. FCA Policy Statement on New Decision Making Process

In July 2021, the FCA consulted on amending its decision making process, in particularly proposing to transfer certain decision-making authority from the FCA's RDC to senior members of the FCA's staff. Notwithstanding significant negative feedback to this consultation, in November 2021 the FCA followed-up with Policy Statement 21/16,[79] which announced that the FCA intended to go through with these changes, and published Final Rules implementing the changes.

Rationale

In the Consultation Paper, the FCA had noted that it wanted "to be more robust and assertive in the decisions [it] make[s] in order to prevent and stop harm faster and more effectively, including being bolder when making decisions".[80] This chimed with comments made by the FCA chief executive Nikhil Rathi in presenting the first FCA Business Plan under his leadership. Mr Rathi stated that the FCA's "instinct will be to test [its] powers to the limit"[81] and that where a case "falls outside [of the FCA's] jurisdiction, it should not mean that [the regulator should] simply stand by".[82] In the Policy Statement, the FCA's primary stated rationale for these proposals is that it they would "result in a more flexible approach and enable decisions to be made more quickly, efficiently and effectively."[83]

An alternative view of these proposals put forward by some was that the FCA was seeking to remove the quasi-independent scrutiny of the RDC in decision making, and in doing so allow the FCA to make "bolder" and novel actions which the RDC might otherwise act as a check against the FCA's attempted enlargement of its powers.

Changes

While the RDC will continue to make decisions in relation to enforcement cases where the FCA is proposing a disciplinary sanction or seeking to impose a prohibition order, the FCA staff will now make certain decisions, including:

- Authorisation: taking final decisions about a firm's application for authorisation or an individual's application for approval which is contested.
- Cancellation: taking action in straightforward cases to cancel a firm's permissions.
- Litigation: commencing civil or criminal proceedings.
- Intervention: using the FCA's own-initiative powers to impose requirements on a firm or to vary its permissions.

Discussion

It is not clear that the FCA's changes to the decision making procedure will have the effect the FCA intended. Indeed, firms and individuals who do not receive a hearing before the RDC, but rather only have a decision made against them by senior members of the FCA staff may (with or without reason) feel suspicious that they have not had a fair process to reach that adverse decision. Indeed, the FCA's changes give rise to significant public law concerns, including:

- The FCA staff will effectively be acting as both the prosecutor and the judge, as they will be seeking

79 https://www.fca.org.uk/publications/policy-statements/ps21-16-new-approach-decision-makers.

80 Consultation Paper, paragraph 2.5.
81 https://www.fca.org.uk/news/speeches/transforming-forward-looking-proactive-regulator.
82 https://www.fca.org.uk/news/speeches/transforming-forward-looking-proactive-regulator.
83 Policy Statement, paragraph 1.30.

the decision to be made, and ultimately making the decision.[84]

- There is a reasonable risk that the decision makers will be perceived as biased, given their role as both prosecutor and judge.
- The changes also include a restriction on a party's ability to make oral representations. Whereas oral representations to the RDC are commonplace, when a senior FCA staff member makes a decision oral representations are now only to be made in "exceptional circumstances", with "exceptionality" to be determined by the decision-maker themselves. As such, parties may be being denied a proper hearing before the decision is made.

84 We note that the public law concerns in relation to the decision as to whether or not to institute civil/criminal proceedings may be lower than for the other decisions, as in those cases the FCA is only acting as prosecutor, and the relevant civil/criminal court will be acting as the judge. This notwithstanding, other public law concerns (particularly bias and the right to be heard) may still undermine the fairness of the decision making.

As such, while the FCA has stated that it intended these changes to allow swifter action and greater flexibility, it seems likely that firms and individuals who may have been happy to abide by a decision of the RDC, may seek to have their cases referred to the Upper Tribunal so that they have had at least one hearing before an independent party. Indeed, such cases may be liable to be quashed by the Upper Tribunal on the grounds that the procedure followed by the FCA was not fair and did not meet the requirements of administrative law. As such, it is possible that the FCA's changes may in fact subject the regulator to greater external scrutiny from the Upper Tribunal restricting what the regulator can do, and cases will take longer.

The FCA has stated that it intends to carry out a six-month post-implementation review to assess the effectiveness of the new reforms.[85]

85 https://www.fca.org.uk/news/press-releases/fca-reforms-decision-making-tackle-consumer-harm.

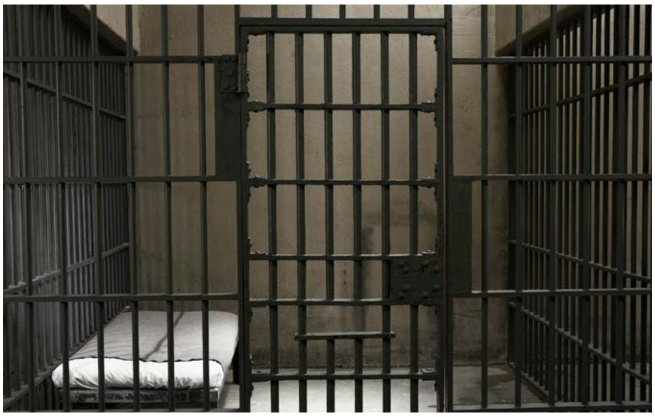
10. Non-Financial Misconduct and Fitness and Properness

The issue of how professional regulators should respond when an individual has been accused of sexual misconduct or convicted of a sexual offence has recently been a hot topic in the UK, whether in relation to solicitors, barristers, doctors or financial services professionals.

In a recent case, the Upper Tribunal has given guidance on how the FCA must approach assessing an individual's fitness and properness to perform regulated financial services following a conviction for a sexual offence.[86] By extension, firms should take note of this guidance, including as part of the assessments they must make at least annually of senior managers and certified staff under the Senior Managers and Certification Regime.

In brief, the Upper Tribunal has made clear that mere conviction of a sexual offence is not sufficient to establish that an individual lacks the fitness and properness needed to work in the financial services sector. Rather, a conviction for a sexual offence will only be grounds for a prohibition order if there is a concrete and convincing link between that offence and the individual's lack of personal integrity as relevant to their professional role.

When assessing an individual's fitness and properness—and when considering an individual's integrity—criminal convictions are obviously important evidence to consider. The FCA, and in turn firms, must scrutinise such non-financial misconduct carefully and determine with persuasive argument whether or not the conviction does in fact affect the individual's integrity in such a way which would make them lack the fitness and properness required for the role.



Fitness, Properness and Integrity

Individuals working in the UK financial sector who perform certain functions have to be approved as "fit and proper": (i) For senior managers, this approval is initially conducted by the FCA itself, and thereafter firms must assess senior managers' fitness and properness at least annually; and (ii) Firms must assess the fitness and properness of certified staff at least annually.

As part of determining whether an individual is fit and proper, the FCA and firms need to consider whether an individual has acted with the integrity required of the role.

Historically, "fitness and properness" assessments largely focused on an individual's conduct at work, particularly their technical capacity to perform the relevant role. In recent years, however, the assessment of fitness and properness has been broadened to become more holistic, with additional emphasis on an individual's conduct outside of the office and "non-financial misconduct". As Christopher Woolard, the FCA's then-Executive Director of Strategy and Competition, stated in December 2018: "[The FCA's] message to firms is clear: non-financial misconduct is misconduct, plain and simple".[87]

The FCA has recently drawn special attention to several cases where it has brought actions to prohibit individuals who have been convicted of sexual offences. Indeed, in the Enforcement Data the FCA published alongside its 2020/2021 Annual Report,

86 https://assets.publishing.service.gov.uk/media/612e14dfe90e07054107585e/Frensham_v_FCA.pdf (*Frensham*).

87 https://www.fca.org.uk/news/speeches/opening-and-speaking-out-diversity-financial-services-and-challenge-to-be-met.

one specific enforcement action was mentioned, namely the prohibition of Mark Horsey who had been convicted of voyeurism under section 67 of the Sexual Offences Act 2003.

In many cases involving non-financial misconduct, including sexual misconduct, it is fairly clear to demonstrate that an individual lacks integrity or honesty. In Mr Horsey's case, for example, his offence occurred in circumstances of breaches of trust, whereby he had spied on his residential tenants. Whilst the FCA's disposition of that case was fairly summary, and the decision was not referred to the Upper Tribunal, the seriousness of the sexual offence coupled with the demonstrated breach of trust and position, served to justify prohibiting Mr Horsey from working in the financial sector.

Frensham v. FCA

Jon Frensham was an independent financial adviser who was convicted of attempting to meet a child under the age of 16 following acts of sexual grooming contrary to section 15 of the Sexual Offences Act 2003. At the time of the offence, Mr Frensham had been on bail for a different offence.

After a significant delay in bringing any action against Mr Frensham, the FCA sought to prohibit him from working in the regulated sector. The FCA argued that a prohibition order was appropriate because, "the nature and circumstances of Mr Frensham's offending show that he lacks integrity".[88] Further, the FCA drew attention to the fact that the offending "involved attempted exploitation of a minor, and abuse of a position of trust and a deliberate and criminal disregard for appropriate standards of behaviour".[89] As such, the FCA argued that it was necessary to prohibit Mr Frensham "in order to maintain public confidence in the financial services industry".[90]

Mr Frensham submitted that the FCA had failed to have regard to relevant facts, including that the conviction was unrelated to his professional activity; he was not convicted of an offence of dishonesty; and there was no connection between the offence and his professional environment (he did not work with children, for example).[91]

88 *Frensham*, paragraph 4.
89 *Frensham*, paragraph 4.
90 *Frensham*, paragraph 5.
91 *Frensham*, paragraph 7.

Based on these submissions, the Tribunal found that it was "not satisfied that a decision to make a prohibition order against Mr Frensham based solely on the fact of his conviction could have been reasonably arrived at by the Authority".[92] The Tribunal determined that the FCA's argument to connect Mr Frensham's conviction to establish a lack of fitness and properness was based on "bare assertions" which were "based only on the awfulness of the offence itself".[93] The Tribunal stated that without additional evidentiary support to demonstrate that Mr Frensham's criminal activity with a child was likely to lead to a "significant risk" that he would exploit other clients, the FCA's case was not made out. The Upper Tribunal repeated several times that the FCA's case was not sufficiently established on evidence.

The Upper Tribunal continued with the following summary:[94]

> *"The Authority is clearly entitled to take into account the nature of the offence in considering the effect it has had on both Mr Frensham's reputation and the reputation of the industry as a whole. … 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 Authority's integrity objective. Furthermore … popular outcry is not proof that a particular set of events gives rise to any matter falling within a regulator's remit."*

This paragraph may be contrasted with statements by the FCA on this topic, including, for example, a letter to the Chair of the Parliamentary Women and Equalities Committee, in which Megan Butler (then the FCA's Executive Director of Supervision) stated firmly: "we view sexual harassment as misconduct which falls within the scope of our regulatory framework".[95] In effect, the Upper Tribunal in this judgment has drawn the FCA back from an overbroad view of its "regulatory framework".

In the context where the FCA has recently announced its intention to "test [its] powers to the limit",[96] and the FCA is proposing its decision making process to allow it to make "bolder" decisions it is perhaps an unwelcome reminder to the FCA that the Upper

92 *Frensham*, paragraph 174.
93 *Frensham*, paragraphs 182 and 183.
94 *Frensham*, paragraph 185.
95 https://www.fca.org.uk/publication/correspondence/wec-letter.pdf, page 1.
96 https://www.fca.org.uk/news/speeches/transforming-forward-looking-proactive-regulator.

Tribunal is able to, and prepared to, keep the regulator within its statutory bounds.

Notwithstanding that the Upper Tribunal disapproved of the FCA's primary reasoning based on his conviction, the Tribunal found on this record that there was an alternative basis upon which a prohibition order could be imposed on Mr Frensham. In this case, this related to other facts surrounding the offence, including that: (i) It was committed whilst he was on bail; (ii) he had failed to be open and transparent with the Chartered Insurance Institute (CII) (of which he had been a member, and was later expelled); (iii) he had failed to be open and transparent with the FCA when the CII had not renewed his Statement of Professional Standing which was a fundamental requirement for him to be able to carry on his business CII) and (iv) he had failed to show genuine remorse.

As such, whilst on different and narrower grounds, the Upper Tribunal agreed that there was a lawful basis upon which a prohibition order could be imposed.

The FCA appears to have approached this case as if it were "straightforward".[97] Indeed, the FCA was strongly criticised by the Tribunal for the way in which it presented this case, with in one instance the Tribunal commenting:[98]

> *"We regret to say that in this respect the Authority has not shown the degree of candour which the Tribunal should reasonably expect and which the Authority would expect from the firms and individuals which it regulates, which, ironically, the Authority maintains was not provided by Mr Frensham in this case."*

As appears to have been the FCA's view, many people may instinctively think that this case is simple, on the basis that they think it should be self-evident that someone convicted of a serious sexual offence regarding a child is not fit and proper to hold a professional role in the financial services sector. The lesson of this case is that these sorts of instinctual reactions are not the correct legal approach, even if—ultimately—it may be rare that someone with such a criminal record will satisfy the fitness and properness requirements.

As stated above, as part of the Senior Managers and Certification Programme, at least once a year, firms have to assess whether their senior managers and certified staff are fit and proper persons. This includes assessing any instances of non-financial misconduct, including alleged or proved sexual misconduct. Firms should also recall that where they discover instances of misconduct—including non-financial misconduct—they may be required to disclose this to the FCA in accordance with the obligation to be open and co-operative with the regulator.

Where non-financial misconduct has a direct connection to the individual's role—for example, if an individual sexually harasses a colleague—it is usually fairly straightforward to demonstrate why the individual does not have the requisite integrity for their professional role.

Where the non-financial misconduct is not directly connected to an individual's position—including that it takes place away from the office—then firms will have to look harder at whether or not the conviction impugns the individual's integrity in such a way that they cease to satisfy the fitness and properness requirements. In such circumstances, firms should be careful not to rely on assumptions or bare assertions in stating that someone lacks fitness and properness.

Firms should also be mindful of the circumstances around the offence—including whether the individual was open and candid with the firm about the offence, and whether or not he/she showed remorse—to consider whether or not these factors also impact the individual's integrity in a relevant manner. For example, an individual who has hidden or downplayed misconduct may lack the integrity required to be a fit and proper person.

97 Indeed, one of the witnesses proffered by the FCA during the Upper Tribunal hearing was the manager of the team which "deals with straightforward Threshold Conditions cases": see *Frensham*, paragraph 76.
98 *Frensham*, paragraph 81.

11. Anti-Money Laundering

2021 saw increased activity by the FCA in bringing anti-money laundering (AML) actions, having brought both administrative actions and obtaining a significant criminal conviction – the first conviction of a bank under the relevant regulations. Whilst the FCA has brought AML cases in the past, 2021 may signal a renewed interest at the FCA in pursuing AML breaches.

National Westminster Bank Plc (NatWest)

On 16 March 2021, the FCA started criminal proceedings against NatWest for failing to adhere to the requirements of regulations 8(1), 8(3), and 14(1), read with regulation 45(1), of the Money Laundering Regulations 2007 ("MLR 2007") between 11 November 2011 and 19 October 2016. Under these regulations, NatWest was required to determine, conduct and demonstrate risk sensitive due diligence and ongoing monitoring of its relationships with its customers for the purposes of preventing money laundering.

On 7 October 2021, NatWest pleaded guilty to the criminal charges with an agreed basis of plea,[99] and on 13 December 2021, Mrs. Justice Cockerill ordered NatWest to pay a fine of over £264 million, a confiscation order of over £460,000 and to pay the FCA's costs of prosecuting the case of nearly £4.3 million.

99 This should not be conflated with a "plea bargain": here, the FCA agreed that NatWest should be permitted to plead guilty on the basis of an agreed statement of the facts. Whilst the defence and the prosecution co-operated to put forward "joint submissions on sentence", the Court proceeded to sentence on the basis of its own consideration of the materials and submissions.

NatWest's breaches involved its relationship with a jewellery company, Fowler Oldfield. As at the date of sentencing 11 individuals had already been convicted, and another 13 had criminal trials scheduled for April 2022.

The case concerned NatWest's handling of funds deposited into Fowler Oldfield's accounts. NatWest had originally refused to take Fowler Oldfield on as a customer, having assessed Fowler Oldfield's business as having too much risk – indeed, NatWest's policies identified businesses involved in the extraction, manufacture and wholesale buying/selling of jewellery as high risk.[100] Fowler Oldfield re-submitted an application, which was considered by NatWest's high risk team, and NatWest agreed on the basis that the bank's relationship manager needed to remain close to the account given its high risk.

This notwithstanding, NatWest's assessment of Fowler Oldfield's business was amended in 2013 from high to low risk, perhaps because the business was re-classified from "precious metals" to "wholesale metals and metal ores", and on noting that Fowler Oldfield was a UK company.

Ultimately, within five years, Fowler Oldfield deposited approximately £365 million at NatWest, of which approximately £264 million was in cash – at the high point, £1.8 million a day was being deposited. Some cash was being brought to the bank in bin bags in amounts which were too large for NatWest's safes to accommodate.

Following a police investigation into Fowler Oldfield in 2016, NatWest reviewed its files and made 13 Suspicious Activity Reports (SARs) to the National Crime Agency, some retrospectively dating back to 2013. It closed Fowler Oldfield's accounts.

100 https://www.judiciary.uk/wp-content/uploads/2021/12/FCA-v-Natwest-Sentencing-remarks-131221.pdf, paragraph 31.

The Court noted that from 2010 to 2015, the NatWest Group had authorised expenditure of £700 million on its AML systems, processes and controls, and is said to have invested over £700 million from 2016 to date in relation to financial crime.

In pleading guilty to the criminal offences, NatWest agreed that it had failed to conduct ongoing monitoring of its business relationships, including failing to scrutinise transactions and failing to keep documents such as its customer due diligence up to date. Further, NatWest agreed that it had failed to conduct risk-sensitive ongoing monitoring, particularly on the basis that Fowler Oldfield was a high-risk customer, and it had failed to apply enhanced ongoing monitoring.

The judge proceeded to sentence NatWest having regard to the guidelines on "Corporate offenders: fraud, bribery and money laundering", and as set out above, imposed a fine of over £264 million, a confiscation order of over £460,000 and to pay the FCA's costs of prosecuting the case of nearly £4.3 million.

HSBC Bank plc (HSBC)

On 14 December 2021, the FCA issued a Decision Notice to HSBC Bank plc fining it £63.9 million for deficient transaction monitoring controls.[101]

The Decision Notice states that between 31 March 2010 and 31 March 2018, HSBC breached regulations 20(1)(a) and (f) of the MLR 2007, because it failed to "establish and maintain appropriate and risk-sensitive policies and procedures" and failed to "establish and maintain appropriate and risk-sensitive policies and procedures for the monitoring and management of compliance with, and internal communication of, those policies and procedures". In particular, the FCA stated that HSBC's monitoring systems did not adequately cover certain risk indicators, there was a failure to set, test and update certain thresholds appropriately, and there was a failure to check the completeness and accuracy of data fed into its transaction monitoring systems.

The FCA noted that HSBC had undertaken a "large-scale remediation programme in late 2012, which spanned multiple years", but "notwithstanding the considerable investment made, the transaction monitoring systems still had serious weaknesses throughout the relevant period".[102]

As a result, the FCA imposed a fine of approximately £63.9 million (which would have been £91 million had it not been for the 30 per cent reduction permitted because HSBC agreed to settle the case). Further, the FCA also noted that "HSBC has undertaken a large-scale remediation programme into its anti-money laundering processes, which was supervised by the FCA".[103]

Sapien Capital Limited and Sunrise Brokers LLP

These were separate actions against each of these two firms, though the underlying facts are similar.

The FCA issued a Final Notice to Sapien Capital Limited on 6 May 2021 requiring it to pay a financial penalty of £178,000, which represented disgorgement. Sapien demonstrated to the FCA that paying a further fine would cause it serious financial hardship, and so the FCA did not impose a further penalty beyond disgorgement, but indicated that it would have imposed a further penalty of £58,740.[104]

On 12 November 2021, the FCA issued a Final Notice to Sunrise Brokers LLP imposing a penalty of £642,400 (which included £407,273 in disgorgement).

Rather than bringing these actions under the MLR 2007 (or the more recent Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017), the FCA brought these two actions on the basis of Principles 2 and 3 of the FCA's Principles for Businesses – Principle 2 requiring a firm to conduct its business with due skill, care and diligence, and Principle 3 requiring a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

Both of these actions were brought on account of the firm executing "purported OTC equity Cum-Dividend Trades", which were then "subsequently reversed over several days or weeks to neutralise the apparent shareholding positions".[105] In each case, the FCA believed it "unlikely that [the firm] would have executed both the purported [Cum-Dividend Trades] and purported [Unwind Trades] for the same [client] in the same stock in the same size trades[,] and

101 Whilst HSBC technically could refer this Decision Notice to the Upper Tribunal within 28 days of the Decision Notice's issuance, there is no indication that it intends to do so, particularly given that it agreed to resolve this matter, and therefore qualified for a 30 per cent discount.
102 https://www.fca.org.uk/publication/decision-notices/hsbc-bank-plc.pdf, paragraph 2.6.

103 https://www.fca.org.uk/news/press-releases/fca-fines-hsbc-bank-plc-deficient-transaction-monitoring-controls.
104 Which would have been reduced by 30 per cent to reflect Sapien's agreement to settle the case at an early stage.
105 https://www.fca.org.uk/publication/final-notices/sapien-capital-limited-2021.pdf, paragraphs 2.4 and 2.5, and https://www.fca.org.uk/publication/final-notices/sunrise-brokers-llp-2021.pdf, paragraph 2.4 and 2.5.

therefore it is likely [that the firm] only saw one side of the purported trading".[106]

In these circumstances, the FCA found that each of the firms "had in place inadequate systems and controls to identify and mitigate the risk of being used to facilitate fraudulent trading and money laundering", and staff did not exercise due skill, care and diligence in applying AML policies and procedures and in failing properly to assess, monitor and mitigate the risk of financial crime.[107]

106 https://www.fca.org.uk/publication/final-notices/sapien-capital-limited-2021.pdf, paragraph 2.8, and https://www.fca.org.uk/publication/final-notices/sunrise-brokers-llp-2021.pdf, paragraph 2.8.
107 https://www.fca.org.uk/publication/final-notices/sapien-capital-limited-2021.pdf, paragraph 2.11, and https://www.fca.org.uk/publication/final-notices/sunrise-brokers-llp-2021.pdf, paragraph 2.11.

12. Key Cases and Enforcement Round-up

Notwithstanding the challenges presented by the pandemic, the FCA and PRA concluded a number of significant cases over the past year with repeated reminders to firms of the need to continue to comply with their compliance obligations.

Credit Suisse

On 19 October 2021, the FCA issued Credit Suisse International, Credit Suisse Securities (Europe) Ltd and Credit Suisse AG (together "Credit Suisse") with a Final Notice[108] imposing a fine of £147,190,276 for serious financial crime due diligence failings relating to loans worth over $1.3 billion, which Credit Suisse had arranged for the Republic of Mozambique. These arrangements were in breach of Principle 2 (a firm must conduct its business with due skill, care and diligence), Principle 3 (a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems) and SYSC 6.1.1R (adequate policy and procedures).

The FCA found that between October 2012 and March 2016, Credit Suisse failed to properly manage the risk of financial crime within its emerging markets business. The FCA held that there was insufficient challenge, scrutiny and inquiry within Credit Suisse in the face of important risk factors and warning signs in transactions. For example, Credit Suisse had sufficient information to appreciate the unacceptable risk of bribery associated with the two Mozambican loans and bond exchange related to government sponsored infrastructure projects (coastal surveillance and the establishment of a tuna fishing industry). Further, Credit Suisse was aware that Mozambique was a jurisdiction where the risk of corruption of government officials was high and that the infrastructure projects were not subject to public scrutiny or formal procurement processes.[109]

It was found that the Mozambique project contractor secretly paid over $50 million in kickbacks to members of Credit Suisse's deal team (including two managing directors), in order to secure the loans on more favourable terms, while certain Credit Suisse employees took steps to conceal the kickbacks. Currently, three Credit Suisse employees have pled guilty to criminal charges in relation to this matter in the United States.

The FCA found aggravating factors to be that: (i) Credit Suisse had previously been notified about the FCA's concerns in relation to this issue in both supervisory meetings and email correspondence; and (ii) Credit Suisse's previous disciplinary history. Credit Suisse agreed to resolve the case with the FCA, qualifying it for a 30 per cent discount in the overall penalty, and also provided an undertaking to the FCA to forgive $200 million of the debt owed to it by the Republic of Mozambique (without which the penalty would have been higher). The outcome was part of an approximate $475 million global resolution agreement involving the US Department of Justice, the US Securities and Exchange Commission, and the Swiss Financial Market Supervisory Authority. The FCA's Final Notice emphasised the requirement for firms to adequately consider important risk factors both individually and holistically.

Standard Chartered Bank

On 17 December 2021, the Prudential Regulation Authority (PRA) issued a Final Notice to Standard Chartered Bank, imposing a financial penalty on it of £46,550,000 for breaches of Fundamental Rule 6 ("A firm must organise and control its affairs responsibly and effectively", somewhat equivalent to the FCA's Principle 3) and Fundamental Rule 7 ("A firm must deal with its regulators in an open and co-operative

108 https://www.fca.org.uk/publication/final-notices/credit-suisse-2021.pdf.

109 https://www.fca.org.uk/news/press-releases/credit-suisse-fined-ps147190276-us200664504-and-undertakes-fca-forgive-us200-million-mozambican-debt.

way, and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice", somewhat equivalent to the FCA's Principle 11).[110]

The breaches in this case related to the PRA's concern in late 2017 that there was a heightened risk in relation to Standard Chartered's USD liquidity outflows, as a result of which the PRA asked Standard Chartered to meet certain specified "new expectations", and to demonstrate compliance through daily regulatory returns. Standard Chartered agreed that it would meet those new expectations.

Over a 15-month period, however, Standard Chartered identified five errors which meant that its regulatory reporting was incorrect, which meant that the PRA's expectations had been missed on 40 days.

As a result, the PRA found that Standard Chartered had failed to organise and control its affairs responsibly, and that it had failed to be open and co-operative with the PRA.

The PRA found the breach of Fundamental Rule 7 (similar to the FCA's Principle 11) was particularly serious, including because there had been opportunities for Standard Chartered's staff to notify the PRA of errors at meetings which had been convened to discuss liquidity and market conditions, but they had not done so.

Metro Bank plc

On 21 December 2021, the PRA issued a Final Notice to Metro Bank for breaching Fundamental Rule 2 ("A firm must conduct its business with due skill, care and diligence", similar to FCA Principle 2) and Fundamental Rule 6 ("A firm must organise and control its affairs responsibly and effectively", similar to FCA Principle 3) of the PRA Rulebook.[111] The PRA fined Metro Bank £5,376,000. Metro Bank settled with the PRA, and as such its financial penalty had been discounted by 30 per cent from £7,680,000.

The PRA found that Metro Bank had failed to ensure that it applied the relevant guidance on Risk Weighted Assets, which led to Metro Bank having to make an adjustment of its assessment of its Risk Weighted Assets of approximately £900 million in December 2018.

At the heart of the breaches found, the PRA noted that Metro Bank had pursued a rapid growth an expansion plan, but had failed to ensure the commensurate development and investment in governance arrangements and systems and controls relating to its regulatory reporting. As a result, the PRA found that Metro Bank's arrangements in respect of regulatory reporting were inadequate.

Lloyds Bank General Insurance

The FCA issued a Final Notice[112] against Lloyds Bank General Insurance Limited, St Andrew's Insurance Plc, Lloyds Bank Insurance Services Limited and Halifax General Insurance Services Limited (together LBGI) LBGI on 8 July 2021, fining LBGI £90,688,400 for failing to ensure that language contained within approximately nine million communications of home insurance renewals communications, between 1 January 2009 and 19 November 2017, was clear, fair and not misleading. The FCA found that LBGI had breached Principle 3 (a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems) and Principle 7 (a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading) of the FCA's Principles for Businesses.

In particular, LBGI did not substantiate 'competitive price' claims included in its renewal communications, which risked serious consumer harm to LBGI's home insurance customers, as policies were renewed in response to approximately 87 per cent of renewal communications containing this language. The FCA found that in actuality LBGI's renewal premiums offered to home insurance customers would have increased when compared to their prior premium and also likely have been higher than the premium quoted to new customers (or customers that chose to switch insurance provider), particularly for customers who renewed repeatedly. Further, LBGI falsely informed approximately 500,000 customers that they would receive a discount based on either their 'loyalty' or their 'valued customer' status, or otherwise a discount on a promotional or discretionary basis, however this hypothetical discount was not applied/never intended to apply. This affected approximately 1.2 million renewals, with approximately 1.5 million communications sent by LBGI. The erroneous discount language was only identified and rectified by

110 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-action/final-notice-from-pra-to-standard-chartered-bank.pdf.

111 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-action/final-notice-from-pra-to-metro-bank.pdf.

112 https://www.fca.org.uk/publication/final-notices/lloyds-bank-gi-st-andrews-insurance-lloyds-bank-insurance-services-halifax-gi-services-2021.pdf.

LBGI during the course of the FCA's investigation.[113]

LBGI has undertaken a consensual redress programme and is voluntarily making payments of approximately £13.6 million to customers who received communications that erroneously referred to the application of a discount when none was applied. The FCA took this into account in the assessment of LBGI's financial penalty. LBGI's penalty is one of the largest fines imposed in the FCA's history and demonstrates a wider effort by the FCA to clamp down on insurance businesses which take advantage of loyal customers.

Adrian Horn

On 3 March 2021, the FCA issued a Final Notice[114] against Mr Adrian Horn, a former market making trader at Stifel Nicolaus Europe Limited, for market abuse in contravention of article 15 of the EU Market Abuse Regulation[115] (EU MAR), and imposed a prohibition order pursuant to section 56 Financial Services and Markets Act 2000 (FSMA), prohibiting Mr Horn from performing any functions in relation to a regulated activity. The FCA imposed a £52,000 fine.

The FCA found that Mr Horn engaged in market abuse by 'wash trading'. Mr Horn intentionally placed buy orders in McKay Securities Plc shares that traded with his existing sell orders (and vice versa), totalling 129 wash trades during the period of 18 July 2018 to 22 May 2019. Mr Horn's wash trading gave false and misleading signals to the market as to demand for and supply of McKay shares resulting in other market participants seeing what they believed to be legitimate trades of McKay shares, and artificially inflating end of day trading volumes reported to the market. The FCA held that Mr Horn was aware of the risk that his actions might constitute market manipulation but nonetheless recklessly proceeded with them. The FCA further found that Mr Horn executed the wash trades in an attempt to help McKay remain in the FTSE All Share Index.[116]

Mr Horn's financial penalty was reduced by 25 per cent and he received a further 30 per cent settlement discount due to his high level of cooperation during the investigation and significant early admissions at interview (held to be mitigating factors).

113 https://www.fca.org.uk/news/press-releases/fca-fines-lbgi-90-million-failures-communications-home-insurance-renewals-2009-2017.

114 https://www.fca.org.uk/publication/final-notices/adrian-horn.pdf.

115 Regulation (EU) 596/2014, as it then applied when the UK was a member state of the European Union.

116 https://www.fca.org.uk/news/press-releases/fca-fines-and-prohibits-trader-market-abuse.

Omar Hussain

On 11 October 2021, the FCA issued a Final Notice[117] against Mr Omar Hussein, a former director and senior financial adviser at pension switching firm, Consumer Wealth Ltd (CWL), which imposed a financial penalty of £116,000 pursuant to section 66 FSMA for providing reckless and unsuitable pension switching advice, and which prohibited Mr Hussein from working in financial services.

Between 2015 and 2017, Mr Hussein and CWL advised 620 customers to switch their respective pensions into a self-invested personal pension (SIPP) containing significant investments in 'Portfolio 6', an investment offered by the Discretionary Fund Management firm, Greyfriars Asset Management LLP. Portfolio 6 was a high-risk investment comprised of unregulated mini-bonds relating to overseas investments in car parks, renewable energy and holiday resorts. Portfolio 6's investments were illiquid and unsuitable for low net worth, financially inexperienced individuals. Mr Hussein's misconduct put at risk an estimated £13.5 million of CWL customers' retirement savings.

Accordingly, the FCA found that Mr Hussein acted recklessly and abused a position of trust when advising CWL's clients, who were often financially inexperienced, vulnerable and had no or limited capacity for loss. Further, My Hussein charged fees for a non-existent on-going advice service. Mr Hussein was also aware of the FCA's pension alerts reminding advisers to assess the suitability of the underlying investments held in a SIPP when advising a switch, and that non-mainstream investments were unlikely to be suitable options for the vast majority of retail customers.[118]

Mr Hussein agreed to settle with the FCA at an early stage of the investigation and therefore qualified for a 30 per cent discount, without which, the FCA would have imposed a fine of £165,797.38.

Ian Hudson

On 20 May 2021, the FCA announced that it had commenced criminal proceedings against Mr Ian Hudson,[119] and on 26 July 2021, Mr Hudson was sentenced to 4 years' imprisonment for fraudulent

117 https://www.fca.org.uk/publication/final-notices/omar-hussein-2021.pdf.

118 https://www.fca.org.uk/news/press-releases/fca-prohibits-fines-omar-hussein-pension-switching-advice-failings.

119 https://www.fca.org.uk/news/press-releases/fca-charges-ian-hudson-fraudulent-trading-regulated-activities.

trading in breach of section 9 of the Fraud Act 2006, for carrying on a business, Richmond Associates, for a fraudulent purpose, and for carrying on regulated activities (accepting deposits and advising on investments) when not authorised or exempt, in breach of section 23(1) FSMA.

Between 1 January 2008 and 31 July 2019, Mr Hudson advised on regulated mortgages, pensions and other investments and purported to invest significant client deposits, totalling approximately £2 million, in various financial vehicles or to be put to specific uses. However, it was found that Mr Hudson actually used those deposits to re-pay existing clients, make payments to other individuals, or to fund his own lifestyle. Mr Hudson was not at any point authorised by the FCA to undertake these, or any other, financial services.[120] The FCA has stated that it will pursue confiscation proceedings against Mr Hudson to compensate victims.

120 https://www.fca.org.uk/news/press-releases/ian-hudson-imprisonment-fraudulent-trading-activities.

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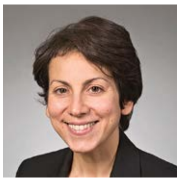

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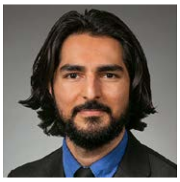

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