INTERNAL AUDIT SUPPORT

INVESTMENT AND WEALTH MANAGEMENT

December 2023

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A RETROSPECTIVE ON 2023 BY A HEAD OF INTERNAL AUDIT

RICHARD WEIGHELL
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ANOTHER YEAR APPROACHES ITS END

A retrospective on 2023 by a Head of Internal Audit

As 2023 creeps into its last month and the various internal audit plans that I am responsible for are getting the endorsement of the Audit Committees, I have allowed myself a bit of time to reflect.

There has been a lot going on in 2023. Not quite the turmoil of 2020 to 2022 with no events quite like Covid, withdrawal from the EU or rapid changes in Prime Minister, but still, plenty for FS firms to be anticipating and responding to.

So, what have been the big issues of 2023? The ones that have stood out for me are:

- The sharp increases in interest rates – nothing like the fluctuations or levels of when I first started out in the business (remember the ERM and your first mortgage?), but very high against recent norms. This has meant that there have been big winners and losers. Those funded by deposits have tended to do well. Those dependent on borrowing/securitisation, handling non-cash investments or trading have been hit hard as margins and volumes fall.
- The cost-of-living crisis continues and has become more challenging. This is driving increased credit risks, withdrawal of savings and a sharp upturn in attempted frauds.
- The increasing duty of care and expectations around behaviour for firms. In particular, we have seen Consumer Duty come in. This sets new levels of considerations for retail customers, which required significant effort to get to the base implementation earlier this year (31 July), with lots more still to be done. And then there is the focus on demonstrating responsible behaviour and strong governance as a business, highlighted by ESG expectations and the regulatory focus on governance as being the root of good and bad firm behaviours.

These strategic pressures on FS businesses are quite rightly attracting the attention of internal auditors. But Heads of Internal Audit are also facing a raft of operational pressures too, as we've seen from responses to our recent Heads of Internal Audit survey. In particular:

- 50% of respondents see their biggest concern as having insufficient resources and specialist skills budgeted to deliver the 2024 plan. The changes and challenges for businesses mean that the number and severity of risks for internal audit to be considering is in many cases increasing. A number of these are in new or areas not traditionally covered by internal audit and, therefore, there is a need for constant upskilling of the teams and the challenge of being able to say with confidence what good looks like. At the same time, it is a tough market to recruit in, with the most in-demand skills coming at a premium cost;
- 50% of audit leaders have either a larger or much larger 2024 plan of reviews compared to 2023. Just as these demands are increasing, the budgets for internal audit functions are being squeezed, particularly in sub-sectors where profitability is reduced. This means that Heads of Internal Audit need to work out where to target their limited resources to get the best coverage and most impact without leaving too many gaps;
- The increased pressure on internal audit to demonstrate quality. Nearly 90% of respondents will rely on a combination of co-source support and external training of existing IA team members to address specialist subjects, such as cyber, Consumer Duty and prudential regulatory requirements to ensure the expected level of quality behind audit work. QAIP and EQAs have been in the IIA Standards for a long time, but over the last two years we have seen a much higher take up of EQAs and a lot more requests for support in helping to improve functions. This is unsurprising when we look at the CIIA's aggregated results for the EQAs it undertook in 2022/23 - the area of an IA function with the lowest rate for 'Generally Conforms' was the QAIP (second lowest was Planning); and
- 56% of respondents expect the reviews planned for 2024 plan to involve a range of 10% - 25% of delivery activity to be based on data analytics. The challenge to enhance the use of data and CAATs in delivering whole population testing and continuous auditing is intensifying, with larger IA functions leading the sector. Smaller and mid-sized internal audit teams will, if not already in place, need to have a data-literate co-source partner to keep pace with the evolving data-led landscape.

So, it is an interesting time for internal audit, with plenty of challenges, and I cannot see that reducing during 2024.

However, Heads of Internal Audit have always dealt with challenges, and it tends to attract the sort of people who relish them. This is what has kept me in the business.

Therefore, I have every confidence that Heads of Internal Audit will find their way through. And hopefully the guidance in this publication can help you.

02

DIVERSITY & INCLUSION (D&I) UPDATE

SASHA MOLODTSOV
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DIVERSITY AND INCLUSION (D&I)

On 25 September, the FCA and PRA published their respective Consultation Papers (CPs), focusing on diversity and inclusion (D&I) in regulated firms. These CPs had been long awaited following several regulatory initiatives over the last few years, with the FCA and PRA inviting feedback on the proposals by 18 December 2023.

The Regulators make their expectations clear on the role risk and control functions should play in ensuring the risks emerging from poor D&I practices are managed alongside other business risks. Supported by the Chartered Institute of Internal Audit's technical paper on 'Auditing Diversity and Inclusion', the CPs explain how internal audit teams are uniquely placed to not only ensure compliance with regulatory and legal requirements, but also assess how effectively diverse and inclusive practices are embedded in firms' overall governance, culture and business processes. Internal audit is also seen to have an important role in supporting accountability, ensuring that findings from D&I reviews are being appropriately reported to senior leadership and the Board such that they can be used to monitor progress, inform improvements to strategy over time, address any deficiencies, and make targeted interventions as appropriate.

This article highlights some of the key PRA and FCA proposals as well as important next steps all internal audit teams should consider in preparation of the new rules expected to be published in 2024.

D&I Strategies

The Regulators propose that the Board is responsible for setting, approving and adopting an appropriate D&I strategy, with clear oversight over its implementation. Dual regulated firms (except for third country branches) are also expected by the PRA to have their own Board D&I strategy. Rules are being proposed which require Boards to develop and publish 'a strategy promoting diversity and inclusion', also applicable to Board sub-committees. The Regulators also propose that firms develop an evidence-based D&I strategy that contains, at a minimum:

- the firm's D&I objectives;
- a plan for meeting these objectives and measuring progress;
- a summary of the arrangements in place to identify and manage obstacles; and
- activities to ensure adequate staff understanding of the firm's D&I strategy.

The PRA also expects the strategy to include details around the firm's core values and the culture that it is trying to create, the role of the firm and staff in fostering an open and inclusive environment.

Through some of the internal audit reviews BDO has recently performed, it has become clear that there is a great variance in maturity across the sector. Some firms are at early stages of developing their D&I strategy and have not yet embedded it, whilst others have a strong alignment between their overall business strategy, talent and D&I strategy, with established roles and responsibilities, inclusive practices across the employee lifecycle and clear D&I ambitions and action plans.

Reporting

Both Regulators propose for all FSMA firms with a Part 4A permission and CRR and Solvency II firms of any size to be required to annually report on their total UK employee numbers at an individual level. Firms with >251 UK employees are required to complete a joint regulatory return covering the following demographic characteristics:

- age;
- ethnicity;
- sex or gender;
- religion;
- disability or long-term health conditions; and
- sexual orientation.

Gender identity, sex or gender, socio-economic background, parental and carers responsibility are voluntary to report against. The Regulators also expect firms with >251 UK employees to report annually on workplace inclusion, introducing consistent measures of inclusion reporting to provide a baseline of data within firms and across the sector.

Irrespective of a firm's size and whether it is required to publish their D&I data externally, management and the Board should be receiving and reviewing D&I Management Information (MI), using it to inform the D&I strategy, make timely interventions and monitor progress against the firm's strategic objectives. In many of the D&I internal audit reviews BDO has conducted, this is an area that often requires the greatest improvement. Firms' D&I dashboards typically have limited data sets (for example, due to low disclosure rates, or limited data collection) with little root cause analysis or qualitative input.

Disclosure

The PRA's proposals for disclosure build upon the FCA's, further requiring firms to disclose their Board and firm-wide D&I strategies, in addition to details around the policy for achieving the D&I targets, supporting narrative and rationale for the targets.

Internal Audit has a key role to play in assessing D&I data controls, ensuring governance and accuracy over data collection and reporting, ahead of firms making public disclosures alongside their annual reports, often for the first time.

Setting targets

With regards to setting D&I targets, the Regulators are largely aligned in their proposals. All firms with 251 or more employees are required to have targets, which firms set for themselves, to address underrepresentation of demographic groups for the Board, senior leadership, and throughout the employee pipeline.

DIVERSITY AND INCLUSION (D&I)

The PRA proposes that targets are set for gender and ethnicity at a minimum, should firms identify under-representation in these groups. The FCA, on the other hand, does not propose to mandate which demographic characteristics the targets should cover.

Whilst Regulators make it clear that "failure to achieve quantitative targets related to diverse representation of demographic characteristics would not necessarily amount to failure in meeting their responsibilities overall", internal audit can support a firm in the evidencing of 'reasonable steps' being taken. The CPs describe reasonable steps as "efforts to implement a well-developed and evidence-based strategy, and an understanding of how a firm should address strategic shortcomings on diversity and inclusion over time".

What should Internal Audit teams think about?

Whilst the new rules will come into force 12 months from publication of the Policy Statements, internal audit teams should consider D&I as a business risk and ensure it is managed alongside other business risks.

Internal audit teams should support their firm by developing a clear picture of what its unique D&I position is, identifying the gaps and preparing for the new rules coming into force in 2024. Avoiding a compliance 'tick box' approach and working in a silo, firms should use this time to review and assess the design, and where possible, the effectiveness of their D&I strategies, ensuring they are embedded in existing ESG strategies, as well as risk, control and governance frameworks.

For more information on how BDO can support your Internal Audit teams, please speak to Sasha Molodtsov, Partner, Financial Services.

03

BEHAVIOURS & CULTURE

WHY IT MATTERS – PART 2

ALISON MACKEY
Associate Director

BEHAVIOURS & CULTURE

Why it matters – Part 2

People's behaviour is driven by what they see and hear around them. The social norms are perceived as 'rules of behaviour', with those rules informing people how to feel and behave in certain situations.

If we think about the social norms which impact us every day, for example, queuing etiquette when we wait for a coffee, or holding the door open for someone when their hands are full. It is these 'unwritten rules' which influence our reactions. The workplace is no different.

Going back to the example of UBS' rogue trader, Kweku Adoboli, understanding the organisational context within UBS and how this was likely to have been connected to Adoboli's unauthorised trading would have been useful to understand. For example, whether there were examples of dysfunctional leadership and ineffective reward and incentives structures which impacted Adoboli's behaviour.

As Part 1 of this series addressed in our last update, understanding behaviours is critical to understanding the risks that organisations face. To do so, we need to understand the context within which individual teams operate, and the shared attitudes and beliefs which create that teams' 'sub-culture'.

It is often assumed that organisational values, purpose and strategic intent are mirrored throughout the company and that once you have understood one culture, you have understood them all. This certainly is not the case.

Sub-cultures exist where groups of people create their own shared norms, values and practices. It should be noted that sub-cultures do not necessarily equate to 'bad behaviour', as is sometimes the assumption, but the specific attitudes and mindsets in these groups should be explored and understood in firms when thinking about risk and culture.

The following approach could be considered when trying to understand behaviours and sub-cultures.

Understand where to look

- As mentioned in November's update, start by asking questions about the firm's wider culture and use that information to form a view of where you may want to focus your efforts. Are there specific teams/business areas which are of a concern?
- Look across your current and previous audit plan and think about which business areas have been subject to coverage. Are there teams who have had problematic relationships with other parts of the firm or failed to appropriately prioritise risk management?

Hypothesis-driven or blank sheet of paper?

- You may know of a particular issue you want to address (e.g., poor leadership behaviours) and, therefore, using a hypothesis-based approach may be effective. The testing in this scenario will likely be targeted to prove or disprove your hypothesis;
- The broadest approach to understanding behaviours, and the risks that they drive, is to start with a blank sheet of paper: no assumptions or prior knowledge of specific issues. This will facilitate a deep analysis of various aspects of behaviours and culture and may unearth multiple issues.

Use a variety of testing methods

- Gathering a range of data using qualitative and quantitative methods is the most effective for identifying patterns of behaviour. It also provides the auditee confidence that your conclusions can be corroborated with multiple sources of information;
- Group your questions around specific topics (i.e., leadership style, communication etc) to better support the subsequent analysis and reporting stages;
- Consider using the following methods: semi-structured 1:1 conversations; surveys; observations and walkthroughs; and desktop review of HR reports.

Analysing and reporting the data

- Tie the data back to your controls where appropriate, but also link to your specific topics;
- Think about patterns of behaviour, where are you seeing similar things emerge from the data (e.g., people's perceptions of management are that they don't want to be challenged);
- Applying judgement is key here, therefore ensure there is quality assurance from a subject matter expert or cosource advisor who can also provide benchmarking against comparable teams in other firms. This will help to minimise any bias and constructively challenge your conclusions;
- Use verbatim quotes from conversations and the survey. Verbatim comments are incredibly powerful when reported to management;
- Always tie results to risk. What are the unintended consequences of the behaviours that you are observing? What would the senior management and Board of the firm reasonably expect to know from this review?

What should Internal Audit teams think about?

- Avoid scripting your 1:1 conversation – there is more value in being semi-structured, i.e., not using a list of questions, but rather some high-level areas to explore with open questions and seeing where the conversation goes
- Take verbatim notes where it could be helpful. Using direct quotes in your reporting to management can have a substantial impact
- Avoid just having 1:1's with management – depending on your scope, you may want to speak to junior members of the team, or employees in other teams that work with the team or business area being audited.

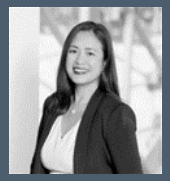
BEHAVIOURS & CULTURE

Why it matters – Part 2

- Incorporate as many free-text questions in the survey as possible – this gives a richness of data which does not always come through the questions. It also gives employees the opportunity to share their views.
- Consider use of a Likert-scale for responses to a survey the survey (Strongly Agree, Agree, Neither agree nor Disagree, etc) as opposed to binary ‘yes/no’ answers.

04

PRUDENTIAL UPDATE



AIZA MARIE SACE
Senior Manager

PRUDENTIAL UPDATE

In Focus: PRA Policy Statement on Non-Performing Exposures Capital Deduction

On 13 November 2023, the Prudential Regulation Authority (PRA) published its Policy Statement (PS) on Non-Performing Exposures Capital Deduction which provides feedback on responses to Consultation Paper (CP) 6/23, which focuses on the capital deduction for non-performing exposures (NPEs).

The capital deduction for NPEs was initially introduced by the European Union (EU) in 2019 with the aim of encouraging European firms to reduce non-performing assets, prevent future accumulations, and mitigate systemic risks. Following the UK's withdrawal from the EU, the NPE deduction requirement was incorporated into UK law through the EU Capital Requirements Regulation (CRR). However, the PRA has evaluated its suitability for the UK, considering the objectives and potential impacts on the banking sector. The PRA proposes not to apply the NPE deduction requirement in the UK.

The final policy statement amends the PRA Rulebook, specifically addressing Own Funds and Eligible Liabilities, Disclosure, and Regulatory Reporting.

Who does this apply to?

The policy is relevant to banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial or mixed financial holding companies.

Summary of the PRA's Policy

The PRA Policy removes the Common Equity Tier 1 (CET1) deduction requirement for NPEs insufficiently covered by firms' accounting provisions and related reporting requirements for CRR firms.

Existing accounting standards mandate firms to account for credit losses by evaluating exposure-specific factors like repayment ability, considering estimated cash flows and collateral values.

The NPE deduction, introduced under the EU CRR, supplements these provisioning requirements, and is set in the PRA Rulebook. It mandates deducting perceived insufficient coverage for new NPEs from CET1 capital.

However, the PRA has identified design flaws, as it was not specifically tailored to UK firms, omitting collateral consideration for secured exposures and lacking alignment with UK-specific circumstances.

The PRA is eliminating the NPE deduction requirement and related reporting templates to simplify reporting and reduce expenses, particularly for smaller firms. The PRA has assured its capacity to oversee provisioning shortfalls using alternative tools if necessary, emphasising the need for a more tailored and effective regulatory approach in the UK. The PRA contends that this approach aligns with its safety and soundness objective and, with forthcoming legislative adjustments, would advance its new secondary objective of fostering competitiveness and growth in the UK economy. These modifications should align the UK rules with the Basel international standards.

Next steps

The rule change to remove the NPE deduction requirement was effective from 14 November 2023, alongside the corresponding adjustments to reporting requirements. With the amended rules in force, firms would no longer be obligated to fill out the associated reporting templates. The PRA plans to make any necessary changes to existing reporting templates and taxonomy at a later date. Firms should also consider the estimated costs and benefits associated with implementing the policy and ensure compliance with relevant statutory obligations applicable to the PRA's policy development process. Keeping abreast of further updates or guidance from the PRA is also essential.

What should Internal Audit teams think about?

Internal Audit teams should consider how they can provide assurance to senior management and the Board in navigating the recent policy changes and regulatory guidelines on own funds.

One significant aspect involves examining the amendments to the PRA Rulebook. The changes specifically address Own Funds and Eligible Liabilities, Disclosure, Regulatory Reporting, and Reporting. Internal audit teams should focus on understanding these modifications and their impact on reporting requirements to assure compliance and avoid regulatory non-compliance risks.

Internal Audit teams should also evaluate the implications of the removal of the Common Equity Tier 1 (CET1) deduction requirement for NPEs on capital adequacy and should be proactive in consulting the necessary adjustments to reporting processes and templates to ensure compliance with the amended rules within the designated timeline.

05

DATA PROTECTION UPDATE

CHRISTOPHER BEVERIDGE
Managing Director of Privacy and Data Protection

DATA PROTECTION UPDATE

ICO issues three fines to Financial Services organisations for illegal direct marketing

In November 2023, the Information Commissioner's Office (ICO) announced that three organisations offering financial services have been fined a combined total of £170,000 for illegal direct marketing under the Privacy and Electronic Communications Regulation (PECR).

The detail

In the recently published article, the ICO outlined the reasons for the financial penalties, which include:

- Sending 415,000 text messages to individuals, encouraging people to obtain free advice, simply by visiting the organisation's website, without valid consent.
- Making unsolicited calls to individuals about pensions, to over 20,000 individuals who were registered with the Telephone Preference Service (TPS).
- Sending and allowing third parties to send over 2.3 million direct marketing text messages to promote services, without holding valid consent from the recipient. Furthermore, none of the messages identified the sender of the message or gave individuals the opportunity to opt out of marketing communications.

The article also highlighted the potential harms and risks associated with high-pressure or predatory marketing communications on elderly or vulnerable individuals, who are most at risk.

What does this mean for financial services firms?

The recent ICO enforcement action highlights a heightened regulatory focus on the sector for financial services firms which do not comply with the UK Data Protection Act 2018 (UK GDPR) and the Privacy and Electronic Communications Regulation (PECR).

The recent enforcement action also serves to warn financial services organisations of the potential risks arising from non-compliance, which can include;

- Substantial financial penalties under both the PECR and the UK Data Protection Act 2018, noting that under recent UK data protection reform proposals the current maximum penalty of £500,000 under PECR will be brought into line with the UK Data Protection Act's penalty structure being the greater of £17.5 million or 4% of global turnover
- Erosion of trust
- Reputational damage arising from high profile action, and
- Increased regulatory scrutiny

What are the basics of processing personal data on the basis of consent?

Under Article 6 of the UK Data Protection Act 2018, organisations are required to cite a valid lawful basis for processing personal data. One of the options available to organisations is the use of consent and to avoid getting caught out, financial services firms should be mindful of the following requirements for data processing on the basis of consent;

- Processing personal data on the basis of consent, means providing individuals with a genuine choice and control over how their personal data is processed;
- Consent should be a positive indication of an individuals' wishes – this means 'opt in' and not 'opt out.' Passive consent is not permitted;
- Consents should be separated out for each data processing activity, to provide individuals with a genuine choice regarding how their personal data is processed – consents should not simply be bundled together;
- It is good practice to document the time and date consent was captured, in the event of a challenge, and to evidence compliance with consent requirements;
- Don't forget that individuals have the right to withdraw their consent at any time, at which point the processing of the individual's personal data should stop. Firms cannot simply 'switch' to an alternative lawful basis; and
- Individuals should have the ability to opt-out of direct marketing activities at any time.

What should Internal Audit teams think about?

Getting consent 'right' can lead to a competitive advantage, by helping to foster confidence and build trust with clients. Internal Audit teams should consider reviewing the firm's:

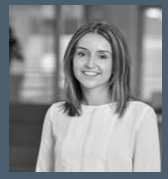
- Data processing landscape - are you comfortable that senior management has visibility of processing on the basis of consent?
- Marketing activity on the basis of consent – are existing consent management processes robust and transparent? Can individuals exercise real choice? Would the firm be able to evidence consent in the event of challenge or regulatory scrutiny?
- Internal processes if an individual withdraws consent – is this manual or automated? Are you assured that your firm no longer sends marketing information to individuals who have withdrawn their consent?

Following the recent ICO enforcement action, financial services firms continue to navigate marketing their services, whilst also maintaining their compliance with the UK Data Protection Act 2018 and the PECR. For further information, or if you have any questions, please reach out to Christopher Beveridge, Managing Director of Privacy and Data Protection, or Louise Sadler, Senior Manager, Privacy and Data Protection.

06

TAX RISK UPDATE

MARTIN CALLAGHAN
Partner, Tax Assurance and Risk Management



EMMA BAILEY
Senior Manager,Tax Assurance and Risk Management

TAX RISK UPDATE

Tax governance and risk management are increasingly on the Board and Senior Management agenda, as well as front of mind for a wide range of external stakeholders including shareholders, potential investors and, of course, tax authorities and the Regulators.

Two significant drivers of this are:

- The Environmental, Social and Governance ('ESG') agenda. Strong values, corporate social responsibility and the governance structures in place to support those values - including tax. This covers compliance, risk management and governance frameworks and the approach to tax planning, structuring and avoidance. Stakeholders in a firm want to know that the firm has a set of strong principles and values that extends to its approach to tax.
- HMRC is focussing its efforts and supervisory resources on the firms most likely to provide the greatest yield – i.e., those they consider to be at highest risk of non-compliance. As part of this, they are adopting a risk-based approach which moves away from time and resource-heavy enquiries and investigations. Instead, they want assurances that companies are getting their compliance right first time through having robust compliance frameworks in place.

Overall, stakeholders require a level of 'visible assurance' in respect of the businesses in which they have an interest.

This can be provided either through compliance with a variety of legislative obligations (for example, Senior Accounting Officer ('SAO') regime, the requirement to publish a tax strategy and Part 3, Criminal Finances Act – the 'CCO' legislation or, importantly, through ensuring a cyclical review of tax controls as part of Internal Audit's annual plan.

A common thread through HMRC's governance reviews is a focus on the documentation of policies and procedures and the testing of those underlying procedures.

As part of this, HMRC can (and do) ask detailed questions around the interaction of the tax and finance team with the Internal Audit function.

What should Internal Audit teams think about?

Tax internal audits, specifically on certain taxes (e.g., reviewing VAT or corporation tax processes), or on tax governance more widely is a core service we at BDO provide our clients. This includes reviewing Tax Governance and Strategy, Tax Risk Management and Tax Performance Effectiveness.

For Internal Audit teams considering a Tax review, here are a number of key planning considerations that can be included in the scope:

Tax Governance and Strategy

- Assessment of how tax accountabilities, roles and responsibilities are defined across the business
- Extent of tax 'tone at the top', including the development and understanding of the group's tax policy and group tax strategy
- How tax risk and issues are escalated to Senior Management and the Audit Committee
- Existence and communication of tax policies and procedures within the business
- Business partnering, namely the strength of interactions between tax and the wider business
- Effectiveness and extent of tax on the board agenda

Tax Risk Management

- Effectiveness of the organisation's tax risk framework, namely the process for identification, assessment, prioritisation and reporting of tax risk
- Managing tax risk in tax planning and commercial decisions
- Management of the organisation's tax profile (ie managing external scrutiny of tax)
- Identification and assessment of controls in place to manage key tax risk issues
- Compliance with the Corporate Criminal Offences legislation

Tax Performance Effectiveness

- Effectiveness of tax compliance & reporting processes (including tax payments) based on discussions with your team
- Documentation of tax decision making
- Capabilities and resource review
- Effective use of technology and automation, based on discussions with your team
- Ability to respond to legislative and regulatory changes, including Budget changes, BEPS, Pillar One and Pillar Two, new legislation etc
- Management of relationships with tax authorities
- Effective use of third-party advisers
- Compliance with Senior Accounting Officer legislation

For further information, or if you have any questions, please reach out to Martin Callaghan, Partner, Tax Assurance and Risk Management, or Emma Bailey, Senior Manager, Tax Assurance and Risk Management.

07

ESG UPDATE

NEW SUSTAINABILITY DISCLOSURE REQUIREMENTS (SDR)

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Director

GLORIA PEREZ TORRES
Associate Director

ESG UPDATE

New Sustainability Disclosures Requirements ("SDR") - what are the new reporting obligations for the financial services sector?

On 28 November 2023, the FCA published the final rules for its (Policy Statement PS23/16) aimed at preventing greenwashing. It includes sustainable investment labels, disclosure requirements and restrictions on the use of sustainability-related terms in product naming and marketing to prevent greenwashing.

The publication of the regime follows a consultation undertaken in October 2022 – January 2023.

The policy statement was originally due to be published by 30 June this year, and then by the end of Q3, before finally being published on the 28 November. The FCA stated the delays were due to the significant volume of written responses to the consultation paper. We understand that other factors, such as the need to consider and align to other international regulatory developments in respect of ESG and sustainability, also contributed to the delay.

What are the key new requirements?

The regime introduces a package of new measures which aim to inform and protect investors, also referred to as 'consumers', and to improve trust in the market for sustainable investments.

The Policy Statement includes an expected anti-greenwashing rule for all authorised firms, four investment labels, and new rules and guidance for firms marketing investment funds in relation to their sustainability characteristics.

Labelling

There will be four voluntary fund labels: Sustainability Focus, Sustainability Improver and Sustainability Impact, along with a fourth label titled 'Sustainability Mixed Goals' to accommodate multi-asset funds.

The threshold for the Sustainability Focus category remains at 70% minimum threshold to all labels. Whilst the sustainability objective should represent the aims of the overall product, the product may invest in other assets for liquidity and risk management purposes, so long as 70% of the gross value of the product's assets are invested in line with the sustainability objective Independent assessment via internal processes or third parties applications.

Disclosure

Funds can voluntarily opt for a label. Consumer-facing disclosure for products not using labels but with sustainability-related terms in their names and marketing must include a statement to clarify that the product does not have a label. Firms with a sustainability objective must identify and disclose whether pursuing the positive sustainability outcomes may result in material negative outcomes through KPIs. There is a requirement to identify and disclose any other assets held in the product for other reasons (e.g., cash, derivatives), including why they are held.

Reporting at the product level will be implemented gradually; for firms with AUM greater than £50 billion subject to the product level reporting requirements from 2 December 2025 and at the entity-level from 2 December 2026.

Naming and marketing rules

The SDR Regime introduces an anti-greenwashing rule which imposes a requirement for all regulated firms to ensure that sustainability-related claims in all marketing materials and communications are clear, fair and not misleading. These include restrictions on the use of sustainability-related terms in the naming and marketing of products and services.

In addition to the anti-greenwashing rule for all firms, sustainability-related terms can only be used in product names and marketing when a label is used, provided that, where the 'sustainability focus', 'sustainability improvers' or 'sustainability mixed goals' labels are used, the word 'impact' is not used in the product's name. Alternatively, they can be used when a label isn't applied but comply with the product name and marketing sections specified in the Policy document.

The naming and marketing rules are effective from 2 December 2024.

Distributors

As in the rules proposed at the consultation phase, distributors must communicate the labels and provide access to consumer-facing disclosures to retail investors. They will be required to keep the labels and consumer-facing disclosures up to date with any changes that the firm makes to a label or the disclosures and will further have obligations to include a notice in overseas products to clarify that they are not subject to SDR.

Who it applies to?

The SDR regime applies to:

- All FCA-regulated firms under the scope of the new general 'anti-greenwashing' rule that requires sustainability-related claims are to be clear, fair and not misleading, effective as of 31 May 2024
- The labelling and classification, disclosure, naming and marketing and distribution rules apply to investment funds and managers (primarily those marketed and marketing to retail investors in the UK), and can be implemented by firms wishing to do so as of 31 July 2024
- Firms that manage or distribute those products also fall under the scope of theses rules effective as of 31 July 2024

ESG UPDATE

What is the anti-greenwashing rule?

Some firms are making misleading sustainability-related claims about their investment products. It is well acknowledged that greenwashing damages consumer trust in the market for sustainable investment products and causes potential harm, such as consumers buying unsuitable products.

The new anti-greenwashing rule, therefore, imposes a requirement for all regulated firms.

What are the specific requirements for Authorised Fund Managers?

In a publication, released on 16 November 2023, the FCA stated that it expects Authorised Fund Managers ("AFM"s) to assess their approach to meeting the current ESG guiding principles, as well as the incoming SDR rules, guidance and principles in relation to their ESG and sustainable investment funds. This request came out of the FCA's findings following review of how 12 AFMs comply with existing regulatory requirements and expectations on the design, delivery and disclosure of ESG and sustainable investment funds.

Overall, the FCA warned fund managers that "further work" was needed to ensure the regulator's guiding principles for ESG and sustainable investment funds are being embedded, signalling that ESG and sustainability is very much a priority for the FCA."

What should Internal Audit teams think about?

Before the 31 May 2024 deadline, Internal Audit can support the firm's anti-greenwashing arrangements. This can be through reviewing their risk assessments and communications, as well as the current approach to promoting and marketing products and services. Teams working with asset managers with sustainability-labelled products should also ensure that these are aligned with the new regime before the 31 July 2024 implementation date.

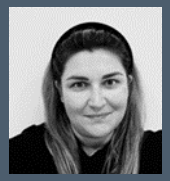
In addition, The FCA expects that AFMs will carry out work to identify and address any shortcomings in the design, delivery and disclosure of their funds, making sure that their products are designed, delivered and disclosed in a way which is consistent with the Guiding Principles, as otherwise they can cause harm to customers. Internal Audit can provide valuable support in this process.

Watch out for our upcoming publications with a more in-depth analysis of the policy statement on our website and participate in our webinars to be held in January and February 2024.

08

ECONOMIC CRIME UPDATE

VLADIMIR IVANOV
Senior Manager



KAREN MONKS
Senior Manager

ECONOMIC CRIME UPDATE

FCA Dear CEO letter on its expectations for Wealth Management and Stockbroking firms

On 8 November 2023, the Financial Conduct Authority ("FCA") published a 'Dear CEO' letter setting out its expectations for wealth management and stockbroking firms.

The letter outlines the FCA's assessment of this sector's key harms and its updated supervisory priorities and included further confirmation of the FCA's expectations for firms for preventing financial crime.

The FCA outlines that it continues to see this sector as an inherently high-risk sector for enabling and/or participating in financial crime, which has damaging impacts on consumers, markets, wider society and the industry as a whole.

In relation to financial crime, the FCA expects firms to:

- Not knowingly facilitate frauds, scams or money laundering
- Understanding their financial crime risk by better understanding their clients
- Do not undertake 'tick box' compliance or outsource responsibility to third parties
- Ensure your systems and controls are effective and robust
- Ensure SMF 16/17 holders have the required skill and independence
- Share and report information of wrongdoing with the regulator immediately
- Read and implement their Financial Crime Guide: A firm's guide to countering financial crime risks (FCG) and Financial Crime Thematic Reviews (FCTR).

The letter concludes that the FCA's supervision of firms will become more targeted, intrusive and asserted. For example, the new dedicated financial crime function for consumer investments will focus solely on identifying firms with key fraud, scams or money laundering indicators.

The FCA also highlights that it has already started a major drive with short notice and unannounced visits, particularly for financial crime, and it is increasing the use of its supervisory tools and powers.

Finally, the FCA will consider in future engagement whether firms have taken appropriate action to rectify the root cause of any issues, which is often poor and ineffective leadership, governance, systems and controls and conflicts of interest management.

What should Internal Audit teams think about?

This again further highlights that the prevention of financial crime continues to be a key supervisory priority for the FCA. This letter reinforces the expectation for firms to have effective systems and controls for managing and monitoring financial crime risk and ensuring that there is clear understanding and ownership of these risks across the Three Lines framework.

In particular, Internal Audit should ensure that:

- Financial crime is a standing agenda item for Senior Management and all discussion and challenge of key financial crime MI is documented in minutes and all action points are followed up and tracked to closure.
- Client on-boarding process and periodic review process are not just tick-box exercises and that all information gathered at on-boarding and throughout the relationship is considered, analysed and documented.
- Financial crime training is specific to the business (rather than generic) and considers the specific risks to which the business is exposed.
- There is a documented annual training plan in place for all employees which clearly outlines the expectations for financial crime training to be completed, this should include role specific training for staff with specific financial crime duties.
- A Training Needs Assessment is considered as part of the annual fit and proper process for staff with specific financial crime duties. This should also be considered as part of the recruitment process for an SMF 17.

Economic Crime and Corporate Transparency Act receives Royal Assent

After lengthy Parliamentary debate and a number of amendments, the Economic Crime and Corporate Transparency Act ("the Act") received Royal Assent on 26 October 2023.

The Act will allow UK authorities to proactively target organised criminals and others seeking to abuse the UK's open economy. Whilst the Act is broad and covers a number of areas, the most important changes for firms will likely be the introduction of the new 'Failure to Prevent Fraud' offence.

Under the new offence, an organisation will be liable where a specified fraud offence is committed by an employee or agent, for the organisation's benefit, and the organisation did not have reasonable fraud prevention procedures in place.

The offence applies to all sectors. However, to ensure that the burden on businesses are proportionate, only large organisations are in scope – defined (using the standard Companies Act 2006 definition) as organisations meeting two out of three of the following criteria:

- more than 250 employees;
- more than £36 million turnover; and
- more than £18 million in total assets.

ECONOMIC CRIME UPDATE

If convicted, an organisation can receive an unlimited fine. Organisations will be able to avoid prosecution if they have reasonable procedures in place to prevent fraud. The government will publish guidance about 'reasonable procedures' before the new offence comes into force.

What should Internal Audit teams think about?

- The 'reasonable procedures' defence mirrors that found in relation to the offence for failing to prevent the facilitation of tax evasion in the Criminal Finances Act 2017. Guidance is expected to be published by the Government and will likely be based on the equivalent guidance for Criminal Finances Act 2017. To avoid being behind the curve when the Government does finally publish its guidance, Internal Audit teams should, therefore, ensure that, as a minimum, their fraud risk management systems and controls meet the 'proportionate procedures', 'top-level commitment', 'risk assessment', 'Due Diligence', 'communication', and 'monitoring and review' guiding principles.
- Considering the increased scrutiny over fraud prevention, Internal Audit teams should also assure that Second Line teams are proactive in reviewing the firm's fraud prevention framework to ensure they meet regulatory expectations and provide sufficient mitigation of the internal and external fraud risks (including those relating to online as well as traditional fraud methods) to which they are exposed.

UK Government publishes formal guidance on ownership and control in respect of sanctions

In our last update, we highlighted the UK Court of Appeal judgment in the Boris Mints & others v PJSC National Bank Trust & PJSC Bank Okritie case ("the Mints case"). The case centred around the extent to which Vladimir Putin and other sanctioned (designated) public officials in Russia could be considered to 'control' entities in Russia for UK sanctions purposes.

Since then, the UK Office of Financial Sanctions Implementation ("OFSI") and the Foreign, Commonwealth and Development Office ("FCDO") issued joint guidance on the application of the UK's ownership and control test under financial sanctions legislation in circumstances involving designated public officials. In respect of control of public bodies, the Guidance states that:

- The FCDO does not generally consider designated public officials to exercise control over a public body in which they hold a leadership function.
- The FCDO does not intend for sanctions targeting public officials to prohibit routine transactions with public bodies, such as taxes, fees, import duties, licences, etc.
- The FCDO would look to designate the relevant public body if it considers that the designated public official exercises control.
- In determining whether a designated individual exercises control over a public body within the meaning of the UK sanctions regulations, a relevant consideration will be "whether the designated person derives a significant personal benefit from payments to the public body, such that they amount to payments to that person rather than the public body".

Regarding control of private entities, the Guidance states that there is no presumption on the part of the UK government that a private entity is subject to the control of a designated public official simply because that entity is based or incorporated in a jurisdiction in which that official has a leading role in economic policy or decision-making.

The Guidance also provides a direct response to the Mints judgment stating that, from a sanctions perspective, the UK government does not consider that President Putin exercises de facto control over all entities in the Russian economy merely by virtue of his occupation of the Russian Presidency.

What should Internal Audit teams think about?

This again illustrates the continued prevalence and importance of sanctions compliance on the Government's wider economic crime prevention agenda.

The Guidance does not necessarily introduce any new concepts, but it does clarify the Government's stance in respect of ownership and control by public officials in the context of sanctions.

Firms should use the Mints case and the FCDO/OFSI guidance to revisit their own internal policies and procedures to ensure that their frameworks provide sufficient clarity and guidance relating to the instances in which entities may be subject to sanctions by virtue of their direct or indirect ownership or control by a designated public official.

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