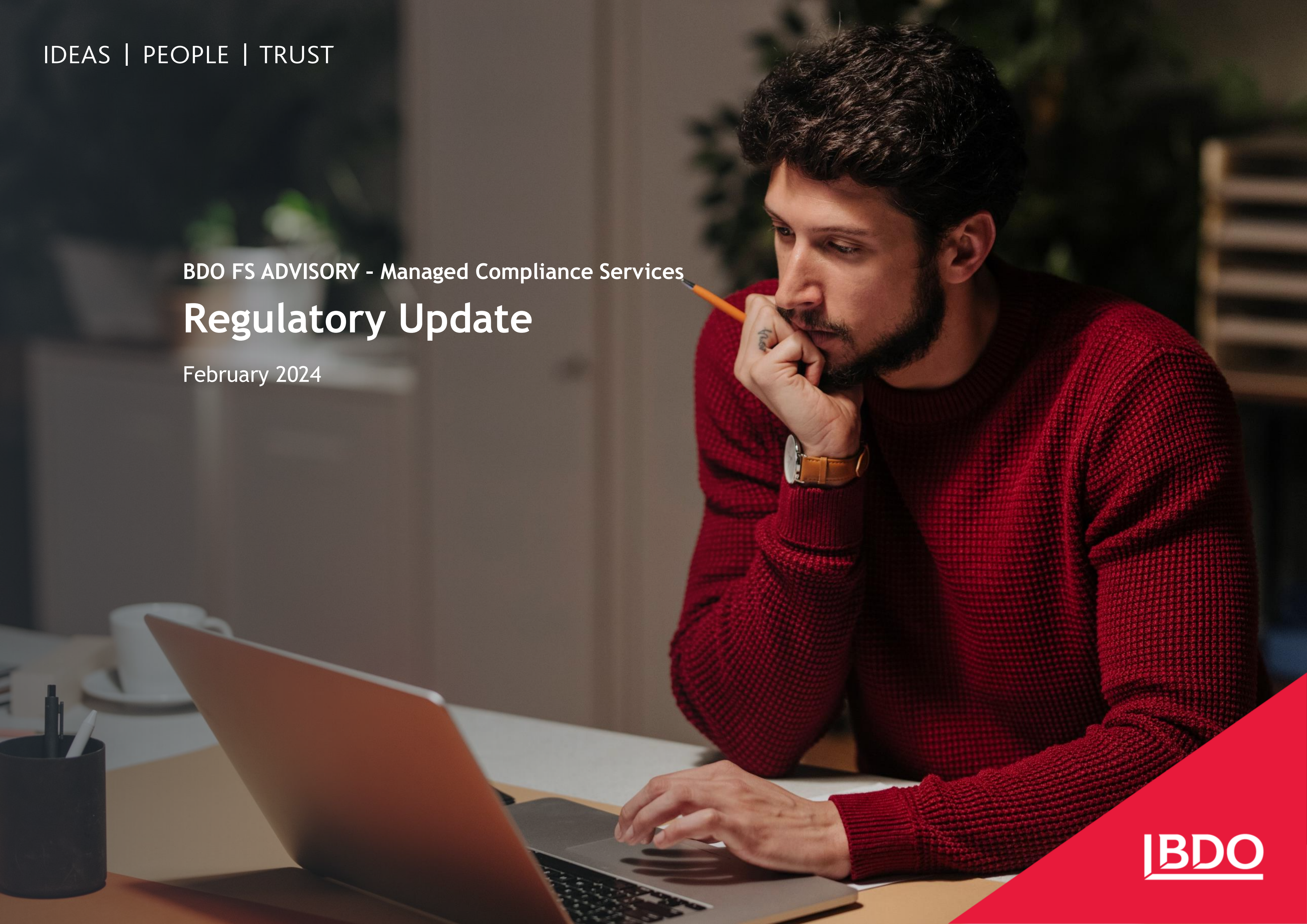


IDEAS | PEOPLE | TRUST

BDO FS ADVISORY – Managed Compliance Services

# Regulatory Update

February 2024

# BDO FS Advisory contact points

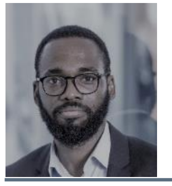
BDO's Managed Compliance Services Regulatory Update summarises the key regulatory developments.

Our FS Advisory team supports hundreds of clients with various regulatory and non-regulatory matters. Our breadth and depth of expertise gives us a broad perspective on the issues facing the financial services sector. We have aggregated insights from our in-house research, client base, the Regulators and professional bodies to support your regulatory considerations and activities.

We hope this pack provides value to you and your colleagues; please do share with us any feedback you may have for our future editions.

**Richard Barnwell**
Partner

+44 (0)7717214818
richard.barnwell@bdo.co.uk

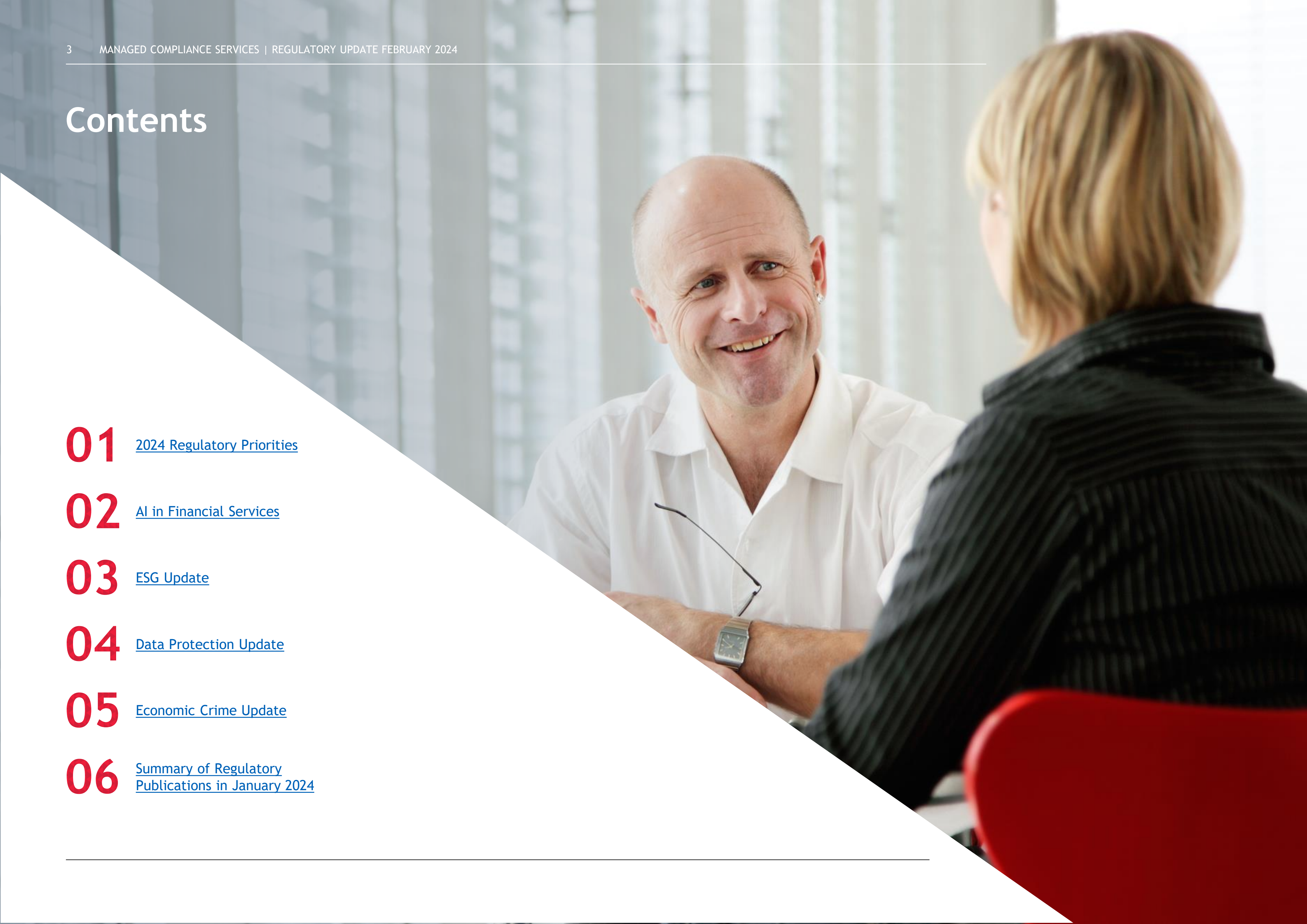


**Osita Egbubine**
Associate Director

+44 (0)7823898762
osita.egbubine@bdo.co.uk

**Lynne Cooper**
Manager

+44 (0)7831973556
lynne.cooper@bdo.co.uk



# Contents

# 01

## 2024 Regulatory Priorities

# Hot topics for 2024 - The Regulators' Outbox

## Investment & Wealth Management

### Regulatory Initiatives Grid

The Regulatory Initiatives grid describes the pipeline of initiatives that are in train to enable industry to plan for implementation.

[Regulatory Initiatives Grid - November 2023]

There are 143 initiatives on the grid. The FCA lead just over 50% and the PRA 16%. The remainder are split between HMT, BOE, TPR, FCR, PSR and ICO.

The political, geopolitical, and economic environment remains unsettled. US presidential elections take place in November. This is also possibly a general election year in the UK, and we could see the regulatory agenda change if there is a change in Government. The bigger change in agenda may, therefore, be in 2025

### What should Compliance and Risk teams think about?

Some of the significant policy initiatives planned this year that Compliance and Risk teams should have on their regulatory radar are as follows:

### ESG

ESG continues to be a heavy part of the regulatory agenda given its strategic importance to UK financial markets and growth. The FCA published the sustainability disclosure requirements (SDR) at the end of 2023, which includes a universal anti-greenwashing rule for all FCA authorised firms. We dive deeper into this topic in part 4 of this update, further below.

Additionally, a new voluntary code on ESG data and ratings was published in December 2023. Further consultation will come from other government departments as well. There is also a range of other enablers such as consultation on climate transition plans; FRC stewardship code; Green taxonomy; and sustainability corporate reporting standards.

There is also an expected consultation covering ESG disclosures and MIFIDPRU clarifications for FCA investment firms. BDO has more detailed information and ESG updates here.

A final Policy Statement on Diversity and Inclusion in the Financial Sector is expected in H1 2024, these proposals will support greater diversity and inclusion across the sector, for example requiring firms to report additional diversity and inclusion related data.

# Hot topics for 2024 - The Regulators' Outbox

## Investment & Wealth Management

### Consumer Duty

As a reminder, the Consumer Duty comes into force for closed products on 31 July 2024. Closed products are products or services no longer on sale for new customers or available for renewal by existing customers.

The supervisory agenda over the last six months has been intense and we can expect to see a continued focus on consumer outcomes and practices the FCA sees as unfair.

Firms need to be on top of FCA communications, their own outcomes assessments and reporting to spot issues and act as needed.

The Board should review whether the firm is meeting consumer outcomes by the first anniversary of the Consumer Duty implementation date, 31 July 2024.

### Advice Gap

The FCA and Treasury are jointly carrying out a holistic review of the boundary between financial advice and guidance.

There have been various initiatives over the years to increase affordable means through which to give more tailored guidance to consumers.

Further proposals are likely to be published later in 2024 following the December FCA Discussion Paper.

### Accessing and using wholesale data

Data is the new gold, and this market study is designed to look at how the market is operating and importantly how participants can access data. This market study is assessing potential competition issues about benchmarks, credit rating data and market data vendors.

The market study update was published on 31 August 2023 and the market study report should be published on, or before, 1 March 2024 at the latest. This might be one to watch.

### Crypto

The evolving crypto market and how to regulate it continues to be a topic regulators are grappling with globally. The UK Government's ambition is for the UK to become a global hub for crypto assets. This is a long haul.

Initial proposals for regulating a broad suite of crypto activities in the UK were published in 2023. Treasury intend to lay secondary legislation in 2024 which will be accompanied by FCA publications.

### Stable Coins

The regulators published Discussion Papers and follow on FCA consultation papers (CP) from both the Bank and FCA will be published circa H2 2024.

The timing of the FCA CP is subject to Treasury secondary legislation being laid.

# 02

## Artificial Intelligence in Financial Services

# Artificial Intelligence: Opportunity, risk, and regulation in financial services

Intelligent systems such as AI and Machine Learning have become increasingly utilized by firms within the Financial Services sector. The growing significance of AI, highlighted by innovations such as ChatGPT, is evidence of the ongoing digital transformation that the industry is experiencing. In the market, we have observed an increasing number of firms utilising AI in a myriad of ways, including the analysis of Big Data in identifying consumer trends, predicting potential financial downturns, and assessing loan repayment capabilities of borrowers.

In this article, we explore the opportunities and risks associated with the use of AI, the current regulatory landscape, and key considerations for FS firms.

## What are the potential Opportunities and Risks associated with AI?

There are undoubtedly significant opportunities as a result of recent AI advances, but there are also a number of risks that firms should be aware of as they look to implement AI-based solutions within their businesses.

**Opportunities:**

- Enhanced Data Analysis and Insights: AI algorithms can process vast amounts of data at high speeds, allowing firms to generate actionable insights from complex datasets. This can result in better decision-making processes and a deeper understanding of market dynamics and consumer behaviour.
- Automated Customer Service: Chatbots and virtual assistants can now provide 24/7 customer service, improving client interactions, particularly in answering FAQs. This will reduce the need for human intervention, which can help redirect focus for addressing complex queries.
- Improved Risk Management: Predictive algorithms can identify potential financial risks, helping firms in proactively assessing and mitigating their risk exposures.
- Fraud and money laundering Detection and Prevention: AI can be used in real-time to identify and flag irregular patterns or transactions in high volume transaction processing, significantly increasing the likelihood of identifying potential fraud events and money laundering breaches.
- Operational Efficiency: Automating manual, time-consuming and routine tasks can result in higher productivity, efficiency gains, and cost savings.
- Tailored Financial Products: By analysing customer data, firms can offer personalised financial products and services, enhancing the user experience and increasing client retention.

**Risks:**

- Data Privacy: As AI relies heavily on data, protecting data privacy is of heightened importance, with the potential for misuse of personal information and potential cyber security breaches.
- Over-reliance on Automation: Heavy reliance on AI may lead to missed human insights, resulting in suboptimal decisions or overlooked risks.
- Job Displacement: As AI continues to automate various tasks and processes, there is a heightened risk to job security.
- Underlying Data Risks: AI models are only as good as the underlying data that supports them; incorrect or biased data can lead to inaccurate predictions or suboptimal decisions by AI models.
- Systemic Herd Behaviour: Where many firms adopt similar AI models, there is an increased risk of ‘herd behaviour’ within financial markets, possibly intensifying market volatility and sensitivity to shocks.
- Ethical and Inclusion Concerns: AI-driven decisions, especially without proper oversight, could lead to unfair, biased or discriminatory outcomes. Firms need to consider their reputation, impact on customers, and regulatory compliance, particularly around data bias concerning protected characteristics, underrepresented groups or the treatment of vulnerable customers.
- Technical Failures: Like any technology, AI systems can malfunction or be vulnerable to cyberattacks, leading to potential financial losses, regulatory discipline or reputational damage. Cyber security systems should be revisited to assess AI cyber vulnerabilities and mitigation.

## What is the regulatory landscape around AI?

In October 2022, The Bank of England (including the PRA) and the FCA published a Discussion Paper (DP5/22) requesting feedback on how the regulator can facilitate the safe and responsible adoption of AI in UK Financial Services. This was published in response to the AI Public-Private Forum (AIPPF) final report, which made clear that the private sector wants the regulator to have a role in supporting the safe adoption of AI in UK financial services.

On 26 October 2023, the FCA and PRA published the feedback statement (FS2/23) which outlined the key responses to DP5/22. The Discussion Paper was published to initiate a debate about the risks of AI and how regulators could respond. Some of the key themes from the feedback include:

- Respondents felt the current regulatory landscape on AI is fragmented and complex, and thus a synchronised approach and alignment amongst domestic and international regulators would be particularly helpful.
- Many participants emphasized the need for more uniformity, especially when tackling data concerns like fairness, bias, and the management of protected characteristics.

# Artificial Intelligence: Opportunity, risk, and regulation in financial services

- Regulatory and supervisory attention should prioritise consumer outcomes, with a particular emphasis on ensuring fair and ethical outcomes.
- Respondents noted that existing firm governance structures (and regulatory frameworks such as the Senior Managers and Certification Regime (SM&CR)) may be sufficient to address AI risks.

Looking ahead, the regulator is expected to produce further guidance by the end of March 2024.

## Other considerations for firms

The use of AI in any sector carries significant ethical considerations, though these are especially pronounced within financial services.

### Transparency and Data Privacy

A recent article by the ICAEW explored the ethics around data privacy and consent in relation to AI. It highlighted the existing use of AI-based insurance risk assessments in dynamic pricing, based on customer responses to health questionnaires.

However, the need to mitigate threats to customer outcomes is critical, especially within the insurance sector where dynamic pricing models can reflect bias or data leaks.

Therefore, transparency in AI, including the ability to delve into an AI model and understand its decision-making process, is crucial in building trust. This can enable consumers to better understand and challenge decisions and outcomes.

However, as it stands for many AI models (including ChatGPT), transparency is weak, leading to the current ‘black box’ paradigm, whereby systems are viewed in terms of inputs and outputs, without sufficient knowledge of internal workings and methodology.

### Bias, discrimination and ESG

AI models trained on historical data can inadvertently perpetuate or amplify existing biases (see our previous article on algorithmic bias and discrimination). AI credit scoring or pricing systems might disadvantage certain demographic groups if past data reflects biases against them. This has the potential to directly contradict firms’ efforts towards promoting Diversity, Equity and Inclusion (DEI), where cognitive, conscious, and unconscious biases affect the training data.

In a best-case scenario, where underlying data is sufficiently free of bias, there is an opportunity for AI to enable organisations to understand inequalities and reduce bias in decision making. AI can be used to better monitor, and help reduce, greenhouse gas emissions, for instance by optimising energy generation and consumption across commercial premises.

### Job Displacement

Automation through AI could reduce the demand for certain roles as technology may be able to replicate these activities, particularly for more junior roles performing manual tasks. The ethical considerations related to this include the societal implications of displacement, the responsibility of firms to their employees, and the impact on recruitment, staff development, talent management, and succession planning.  Conversely, however, initial estimates by the World Economic Forum suggest that whilst AI could eliminate over 80 million roles, it could create almost 100 million new ones, thus the net effect appears positive.

### What’s next?

It is evident that the role of AI will continue to grow, offering clear opportunities for firms to innovate, streamline processes, and amplify their competitive edge, amongst many others.

As firms look to keep up with the competition in the race to deploy AI solutions, there are a number of significant risks that firms will need to manage, which if unchecked could lead to enhanced regulatory scrutiny, litigation, fines and reputational damage. Therefore, establishing the right control environment and governance arrangements early is fundamental to manage the risks to AI.

## What should Compliance and Risk teams think about?

AI could present both opportunities but also serious risks for firms, particularly where models are implemented unchecked and without due consideration of the risks involved. There are a number of key governance and risk management considerations for firms, including:

- There should be a documented process for the review and testing of the AI technology in use.
- Firms should consider the appropriateness of, and enhance where relevant, their governance and oversight arrangements in relation to AI.
- Senior leadership and the Board should consider and understand the relevant risks of the use of AI in the Firm, alongside their roles and responsibilities in regard to the oversight of AI.
- There should be sign-off for technology at a senior level; ensuring that senior leadership understands both the opportunities and risks of the technology and proposed control framework, promoting informed decision making.
- Another crucial factor that firms should consider, is the effect of AI on customer outcomes and its role in delivering good customer outcomes. As such, firms should commit to the ongoing review and measurement of the impact on customer outcomes and any potential unintended consequences resulting from AI.

# 03

## ESG Update

# The FCA's new anti-greenwashing rule: What is it and what steps do you need to take to be ready?

## Background

The FCA's Sustainability Disclosure Requirements and Labelling Regime ("SDR") published on 28 November 2023 is introducing an "anti-greenwashing" rule. Applicable to all FCA-regulated firms, it will require firms to ensure that all sustainability-related claims are clear, fair and not misleading. In addition, any reference to the sustainability characteristics of a product or service must be consistent with the sustainability characteristics of the product or service itself.

The FCA's objective of introducing the anti-greenwashing rule, as per 4.3.1R of their ESG sourcebook, is that it will help to protect consumers from greenwashing while also creating a level playing field for firms offering products and services with genuine sustainable characteristics.

The anti-greenwashing rule was originally proposed to come into effect on the date of the policy statement, however, it was pushed back and will now only be effective from 31 May 2024.

In order to support firms with the implementation of the rule, the FCA published a Guidance consultation paper ("GC 23/3") which is being consulted on until 26 January 2024 with the final guidance expected before the 31 May 2024 implementation date.

## What are the FCA's expectations around the anti-greenwashing rule

Under the proposed GC 23/3, firms will need to ensure that their sustainability related claims are:

- Correct and capable of being substantiated;
- Clear and presented in a way that can be understood;
- Complete – they should not omit or hide important information and should consider the full lifecycle of the product or service; and
- Fair and meaningful in relation to any comparisons to other products or services.

In addition, firms are required to consider the guidance in the context of the Consumer Duty and ensure that they deliver good outcomes for customers.

Ultimately, firms should be able to demonstrate that they are acting in good faith towards their customers, providing them with the information they need, at the right time, and in a clear manner whilst supporting them to pursue their financial objectives.

# The FCA's new anti-greenwashing rule: What is it and what steps do you need to take to be ready?

## Practical steps to consider

There is a short window in which to prepare for the anti-greenwashing rule before it becomes effective at the end of May. Whilst the final guidance, when published, may change, firms should already be starting to prepare to meet the new requirements. The following three practical steps can help firms to get ready:

**Assess if the firm is making any sustainability related statements in relation to its products, services, or business strategy.**

This applies to any customer facing communications or marketing materials that refer to environmental and/or social characteristics of products and services, or about how the firm does its business. In making this assessment, firms should consider communications on the website, annual and financial statements, strategies, policies, and reports.

In addition, as the rule brings into scope images, logos and colours, their use should also be assessed. According to the FCA, claims may be undermined if what they say is factually correct, but their visual presentation conveys a different impression.

**Assess if all communications and marketing materials, offering documents and regulatory disclosures are accurate and consistent with the sustainability characteristics of products and services.**

Firms need to ensure that communications are factually correct. The sustainability or positive social and/or environmental impact of a product or service should not be exaggerated, and any claims should be correct, coherent and consistent across all communications.

Furthermore, it is important that there is a consistent approach across the business around the meaning of the sustainability terms used to avoid inconsistencies, incoherent or incorrect claims.

**Review whether there are appropriate governance and oversight controls over the sustainability communications that the firm makes.**

Firms should ensure that there are appropriate oversight and sign-off processes. In addition, greenwashing risk must be regularly monitored against sustainability reference and claims. Firms should ensure that there is available evidence to support claims made. There should be a process in place to review financial promotions and other communications periodically to monitor and ensure their ongoing compliance with the anti-greenwashing rule.

## What should Compliance and Risk teams think about?

Compliance and Risk teams can use the three practical steps, noted above, to support their firms in preparing for the anti-greenwashing rule. By introducing the anti-greenwashing rule, the FCA is sending a clear message to firms that it intends to challenge them over the firm's sustainability-related communications.

# 04

## Data Protection Update

# UK Data Protection and Digital Information Bill: What is Changing for UK Firms?

## Introduction

The Data Protection and Digital Information Bill was introduced to the UK Parliament in March 2023, marking a significant shift in the UK's approach to data protection and a move away from the EU GDPR. Following its second reading in the House of Lords on 19 December 2023, the draft Bill is now in the House of Lords Committee stage and anticipated to achieve Royal Assent before the next general election.

The Bill is viewed by the UK government as a strategic opportunity to create a new UK data rights regime, balancing technological innovation with robust data protection standards, and aims to alleviate the regulatory burdens on businesses, particularly small and medium-sized enterprises (SMEs).

The draft Bill introduces minor changes to the key concepts and data protection principles outlined in the current UK GDPR. It is worth noting that the UK cannot deviate too greatly from the EU GDPR or could risk losing ‘adequacy status’, which currently permits the free flow of personal data from the EU to the UK.

Furthermore, the draft Bill does not exempt firms from complying with other international data protection laws. For example, firms processing personal data concerning individuals based in the EU will still need to comply with the requirements of the EU General Data Protection Regulation (EU GDPR).

## What does this mean for firms in the financial services sector?

The following represents some of the key changes outlined in the draft Bill which financial services firms need to be aware of:

- **Record of Processing Activities (also known as a ‘RoPA’):** One of the key areas of reform within the draft Bill is a ‘loosening’ of the requirement of controllers and processors to maintain a Record of Processing Activities, which has historically been onerous for organisations, unless they are carrying out high-risk data processing activities. However, the draft Bill has not defined criteria for what constitutes ‘high-risk’ data processing although the Information Commissioner’s Office is expected to publish guidance on this. Furthermore, any organisations which process personal data regarding individuals based in the EU will still be expected to comply with the requirements of the EU GDPR, and therefore will need to maintain a RoPA.
- **“Vexatious” or “Excessive” Subject Access Requests (SARs):** The draft Bill amends the criteria for managing SARs under the UK GDPR, which can also be incredibly onerous for organisations who receive a large volume of requests. The terms “manifestly unfounded” or “excessive” are replaced with “vexatious” or “excessive”. This change provides explanations and guidance regarding what constitutes a vexatious or excessive request, to clarify the grounds on which organisations can refuse or limit their response to SARs.
- **Complaints management:** The draft Bill introduces the requirement for data controllers to acknowledge complaints from data subjects within 30 days and provide a substantive response promptly. The Information Commissioner’s Office will not be obligated to accept a complaint if the data subject hasn’t first approached the data controller.

# UK Data Protection and Digital Information Bill: What is Changing for UK Firms?

- **Data protection impact assessment (DPIA):** The draft Bill proposes a transition from the prescriptive requirement to complete DPIAs to a system of "Assessments of High-Risk Processing," which is expected to simplify the process. The draft Bill removes the specific list of circumstances where a DPIA is required, and instead will rely on guidance from the Information Commissioners Office about which data processing activities require a DPIA. Furthermore, the requirement to consult the Information Commissioners Office in the event of high-risk data processing will become optional under the draft Bill.
- **Changes to the Privacy and Electronic Communications Regulation (PECR):** Changes to the PECR include allowing the use of cookies without consent for web analytics and automatic software updates. The fines under PECR will also be increased to align with UK GDPR levels, up to £17.5 million or 4% of global annual turnover, whichever is higher.

## Case Study - Recent ICO enforcement action in the financial services sector

In December 2023, the Information Commissioner's Office issued a reprimand to the Bank of Ireland (UK) for mistakes made on more than 3,000 customers' credit profiles.

The investigation, (originally reported to the Information Commissioner's Office in 2021) found that the Bank of Ireland UK sent incorrect outstanding balances on 3,284 customers' loan accounts to credit reference agencies. Since credit reference agencies help lenders to decide whether to approve financial products, the error meant that the inaccurate data could have led to affected customers being unfairly refused credit (i.e., for mortgages, credit cards or loans), or granted too much credit for financial products that they potentially could not afford.

The Information Commissioners Office investigation determined that due the to the complex nature of the impact of the error, and different factors which contribute to credit scoring, it would be impossible to quantify the impact on each customer affected but found that the Bank of Ireland UK was in breach of data protection law by failing to ensure that personal data was accurate (per Article 5(1)(d) of the UK GDPR).

To avoid some of the pitfalls highlighted in the case study, above, Compliance and Risk teams within FS firms should provide assurance that the personal data processed by First Line teams is accurate and up to date. This means considering the robustness of the Second Line processes currently in place to oversee that accurate data is captured and maintained on an on-going basis. Audit reviews on this subject should also include testing of the processes for individuals wishing to exercise their right to rectification, i.e., the right to have any inaccurate personal data corrected, and how this feeds back into the data management process of the firm. Corollary to this is the Consumer Duty's expectations for how firms support customers, especially vulnerable customers, with up-to-date information regarding their customers' circumstances when the customer has made effort to provide clarification.

## Further information

Following the recent Information Commissioner's Office enforcement action, organisations in the financial services sector continue to navigate data protection in an ever-changing regulatory landscape. For further information regarding how to navigate data protection legislative changes, 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.

### What should Compliance and Risk teams think about?

The draft Bill heralds a significant shift in the data protection landscape for UK businesses and is poised to reshape how personal data is processed, offering potential benefits such as reduced regulatory burdens.

For firms which are broadly compliant with the requirements of the UK Data Protection Act 2018 and EU GDPR, the proposed changes should have minimal impact, since the draft Bill marks a 'loosening' of existing requirements of current data protection regulation.

However, firms should continue to monitor the passage of the draft Bill and closely follow Information Commissioners Office guidance for greater clarity on key definitions, on revised concepts like "Vexatious" or "Excessive" Subject Access Requests. Our recent case study, below, illustrates the importance of tracking ICO requirements and guidance.

# 05

## Economic Crime Update

# Economic Crime Update

## Domestic PEPs and the firm's risk assessment

On 10 January 2024 the Money Laundering and Terrorist Financing (Amendment) Regulations 2023 ("Amending Regulations") came into force.

The Amending Regulations provide changes to the enhanced due diligence ("EDD") requirements in relation to domestic PEPs (i.e., a politically exposed person entrusted with prominent public functions by the UK).

Specifically, the Amending Regulations amend regulation 35 of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("MLRs") to require that the 'starting point' of any assessment of the risk posed by a domestic PEP is that they pose a lower risk than a foreign PEP.

The new amendment to regulation 35(3A) will provide that:

"For the purpose of [a firm's] assessment [of the level of risk associate with the customer, under reg.35(3)], where a customer or potential customer is a domestic PEP, or a family member or known close associate of a domestic PEP -

- (a) the starting point for the assessment is that the customer or potential customer presents a lower level of risk than a non-domestic PEP, and
- (b) if no enhanced risk factors are present, the extent of enhanced customer due diligence measures to be applied in relation to that customer or potential customer is less than the extent to be applied in the case of a non-domestic PEP".

The Amending Regulations will formalise into law the approach envisaged by the FCA's Finalised Guidance FG 17/6 by requiring a differentiated approach to the extent of EDD applied in relation to lower and higher risk PEPs, with domestic PEPs being rebuttably presumed to be lower risk.

## What should Compliance and Risk teams think about?

Whilst it is likely that most firms will already have been applying this risk-based standard to domestic PEP risk (in light of Final Guidance 17/6), the Amending Regulations now embed it into legislation, meaning that firms should be alive to the changes made, as the onus of complying with regulatory requirements is much greater. Those firms who apply the same level of EDD to all PEPs will require early consideration as they may expose themselves to public scrutiny and unwanted reputational risk by performing "too much" EDD on domestic PEP clients. To ensure a sufficient risk-based approach to EDD based on PEP risks, firms should consider:

- accurately applying the definition of PEPs - are the individuals being treated as PEPs holders of roles which are really senior enough to be PEPs?;
- conducting proportionate risk assessments of UK PEPs, their family members ("FM"), and known close associates ("KCA");
- applying EDD and ongoing monitoring proportionately and in line with risk. For example, whilst Regulation 35(5) illustrates that adequate measures should be taken to establish the source of wealth and source of funds of PEP customers, as part of its risk-based EDD, a firm may choose (as noted in FG 17/6) to apply less intrusive measures (such as only using information which is publicly available) or more intrusive measures (such as requesting independent supporting documentation) in line with the risk of the PEP; and
- keeping their PEP controls under review to ensure they remain appropriate - including how senior management are informed about and oversee operation of PEP controls.

For firms who do distinguish between lower risk PEPs and higher risk PEPs, they will need to consider if the changes to the Amending Regulations have an impact on the way in which PEP risk distinctions are drawn. This may include:

- Does the assessment take into account whether the PEP is a domestic as opposed to a foreign PEP?
- Before a domestic PEP is treated as lower risk, is there a sufficiently holistic risk assessment to ensure that there are no other relevant risk factors present? Such risk factors can include (but are not limited to) -
  - the prominent public functions the PEP holds
  - the nature of the proposed business relationship
  - the potential for the product to be misused for the purposes of corruption
  - any other relevant factors the firm has considered in its risk assessment

## European Council strikes a deal on stricter AML rules

**The 'Anti Money Laundering Authority'**

On 20 July 2021, the European Commission presented its package of legislative proposals to strengthen the EU's rules on anti-money laundering and countering the financing of terrorism ("AML"/"CFT"). These proposals included the creation of a new agency, the Anti Money Laundering Authority ("AMLA"), which was agreed in principle by the EU Parliament and Council of the EU on 13 December 2023. The initial scope of the AMLA's tasks consisted of five broad areas, namely:

- Direct supervision of selected "obliged entities" to ensure group-wide compliance with AML/CTF requirements;
- Supervision of financial sector supervisors to ensure that all supervisors have sufficient resources and powers necessary to perform their tasks;
- Enhancing the supervision of non-financial sector supervisors;
- Financial Intelligence Unit ("FIU") coordination; and
- Rulemaking and guidance.

# Economic Crime Update

## The EU's AML Package

As of 18 January 2024, the Council and Parliament came to a provisional agreement on parts of the AML package. The agreed legislation will contribute to the establishment of an EU single rulebook, prevent disparities between Member States, as well as a lack of enforcement, and will provide with directly applicable European rules to ensure common fight against criminal activity.

The provisional agreement expands the list of "obliged entities" to include new bodies. The new rules will engage most of the crypto sector through requiring all crypto-asset service providers ("CASPs") to conduct due diligence on their customers. CASPs will need to apply customer due diligence measures when carrying out transactions amounting to EUR1,000 or more.

Other sectors concerned by customer due diligence and reporting obligations will be traders of luxury goods, as well as professional football clubs and agents. The Council and European Parliament also introduce specific EDD measures for cross border relationships for CASPs. These include requiring credit and financial institutions to undertake EDD measures in business relationships with high-net-worth individuals. Additionally, the agreement will see the establishment of an EU-wide maximum limit of EUR10,000 for cash payments.

The provisional agreement also makes the rules on beneficial ownership more harmonised and transparent. The agreement clarifies that beneficial ownership is based on two components – ownership and control. Both aspects need to be assessed to identify all the beneficial owners of that legal entity or across types of entity. Accordingly, the agreement previously indicated that it would consider lower beneficial ownership thresholds below 25%; however, the current proposal will see a standardised threshold of 25% across the EU. The related rules applicable to multi-layered ownership and control structures are also clarified to ensure hiding behind multiple layers of ownership of companies will become ineffective.

The European Commission's provisional agreement also expands the power of financial intelligence units ("FIUs") in analysing and detecting money laundering and terrorist financing cases. To increase transparency, FIUs will have immediate and direct access to financial, administrative and law enforcement information. The agreement emphasises that applying fundamental rights is an integral part of FIUs' work and as such, it outlines a framework for suspending or withholding consent to a transaction.

## What should Compliance and Risk teams think about?

While the new EU AML package is not directly applicable to the UK, firms with operations in Europe should anticipate stricter AML regulatory standards and more intensive supervision as the new EU AML regime is introduced.

However, many of the details of the proposed EU AML package are, under the EU's original proposals, dependent on further technical standards and guidance to be prepared by the AMLA and will, therefore, only be available once the AMLA becomes operational.

As such, there may be some further delay until the full detail of the enhanced regulatory standards become available for firms to consider against their existing controls.

Additionally, the UK Government also seeks to be internationally perceived as "top of the class" in terms of financial crime prevention regulation, so it would be expected that the UK may look to any amendments implemented by the EU as an opportunity to enhance its own domestic regulatory landscape.

# 06

## Summary of Regulatory publications in January 2024

# Regulatory round up for February 2024

## General

### Market Watch 76

The Financial Conduct Authority (FCA) has published edition 76 of Market Watch where they share their observations on 'flying' and 'printing', and how firms can mitigate the risks of misleading the market by their staff engaging in these behaviours.

***What firms are impacted?***

Investment firms trading on financial markets.

***Summary of the regulatory update***

Market Watch 57 described the issues as follows:

- Flying involves a firm communicating to its clients, or other market participants, via screen, instant message, voice or other method, that it has bids or offers when they are not supported by, or sometimes not even derived from, an order or a trader's actual instruction; and
- Printing involves communicating, by one of the above methods, that a trade has been executed at a specified price and/or size, when no such trade has taken place.

These activities create a false impression of a financial instrument's liquidity and/or price. As a result, investment decisions of clients and other market participants may be based on misleading information. This might cause financial harm to those participants, as well as undermine the integrity of, and confidence in, the market. Despite the publication of Market Watch 57, the FCA continue to see instances of possible flying and printing in several markets, including fixed income, commodities, and currencies in instruments such as bonds, swaps and options. This has included entering prices in lit markets to generate orders in dark markets.

***When does it take effect?***

This edition was published on 30 January 2024.

***What should firms be thinking about?***

To mitigate the risks of the harms caused by flying and printing firms may want to:

- Ensure compliance manuals prohibit flying and printing, and that annual attestations of compliance are obtained. Senior management should ensure that they effectively communicate their expectations on culture and compliance to policy
- Ensure that training includes the nature of and the prohibition of flying and printing and the consequences of such behaviours. Firms may also want to consider enhanced training for desks considered to be higher risk
- Take all steps to assure themselves that surveillance procedures to identify and report flying and printing are robust, and that the behaviours are considered in risk assessments. Factors to be considered could include properly targeted surveillance to identify spread compression, order cancellation rates, order to trade ratios, and the lexicons embedded in e-comms surveillance systems; and
- Ensure that disciplinary procedures offer clear and consistent processes for dealing with misconduct, and that commercial interests are not drivers of outcomes.

# Regulatory round up for February 2024

## General

### FIN073 Baseline Financial Resilience Report

The Financial Conduct Authority (FCA) has issued guidance on completing the Baseline Financial Resilience Report. This report was introduced to replace the Financial Resilience Survey previously sent in the aftermath of the COVID-19 pandemic.

***What firms are impacted?***

All firms, other than those listed in the summary below.

***Summary of the regulatory update***

The purpose of FIN073 ('Baseline Financial Resilience Report') is to ensure that the Financial Conduct Authority (FCA) receives regular information in a standard format to assist it in assessing the financial resilience of certain firms.

This form should be completed by all firms except:

- a firm with limited permission;
- a MIFIDPRU investment firm;
- a not-for-profit debt advice body;
- a PRA-authorised person;
- a supervised run-off firm; and
- a TP firm.

***When does it take effect?***

The return is due from January 2024.

***What should firms be thinking about?***

Firms should review their RegData reporting schedule to ensure that if they are in scope of the return, the return is now showing on the schedule. Firms which are not in scope should ensure they have not been allocated the return in error. Firms should ensure they are aware of the reporting deadline and should consider the guidance ahead of the return due date. In-scope firms may wish to consult SUP 16.30 for more information.

# Regulatory round up for February 2024

| General |
|---|
| **Portfolio letter: FCA expectations for Investment-based crowdfunding platforms** |
| The Financial Conduct Authority (FCA) has published a letter outlining its expectations for Investment-based crowdfunding platforms. |
| ***What firms are impacted?***<br><br>Investment-based crowdfunding platforms |
| ***Summary of the regulatory update***<br><br>The letter outlines the harms to consumers and markets most likely to arise from Crowdfunding business models, and the FCA's strategy to address those harms. The FCA expects all impacted firms to review its findings, including its good and poor practice examples, and make any changes needed to meet its expectations and improve consumer understanding and ensure good outcomes.<br><br>The FCA stated that they will increasingly use data, already provided through regulatory returns, but now supplemented by direct information requests and intelligence, to assist in identifying outlier firms that pose a heightened risk of harm, whether deliberately or not, and engage with them to mitigate any harm or potential harm. They will proactively engage with firms in the portfolio to ensure that the new rules in PS22/10 have been fully embedded. Where they find weaknesses or failings, that result in poor consumer outcomes, and where there has been the potential for harm, or actual harm to investors, they will be quick to intervene to protect consumers and ensure that redress is put in place.<br><br>An example of this is the FCA recently wrote to all firms in the Crowdfunding portfolio regarding concerns that firms could be misusing the one off non-real time communications exemption (article 28 of the FSMA 2000 (Financial Promotion) Order 2005). They stated that they have come across instances where certain promotional information relating to an issuer's business is made available to retail investors upon request and treated as purportedly outside the scope of application of FCA rules. It is the FCA's view that these 'restricted documents' do form part of the financial promotion and require appropriate due diligence. Moreover, it is clear that a firm's reliance on the exemption when the relevant conditions are not met, simply to avoid regulatory obligations owed to retail investors would breach the requirements of the Consumer Duty. The FCA remain engaged with firms that indicated they do make use of this exemption to determine if they are using it correctly. |
| ***When does it take effect?***<br>This letter was published on the 15 January 2024. |
| ***What should firms be thinking about?***<br><br>Impacted firms should consider the content of the Dear CEO letter to ensure they meet regulatory requirements, including the expectations set out in the Dear CEO letter. Improvements should be made to policies and procedures / systems and controls where deficiencies are found. |

# Regulatory round up for February 2024

| General |
| --- |
| **Consumer Investments Strategy - 2 Year Update** |
| The Financial Conduct Authority (FCA) has published an update on its progress against the workstreams and outcomes it committed to in its Consumer Investments Strategy in September 2021. |
| ***What firms are impacted?***<br>Consumer Investment firms |
| ***Summary of the regulatory update***<br>The FCA has also published its fifth Consumer Investments data review with data from April 2022 - March 2023 regarding its activities to protect consumers from investment harm.<br>In this update, the FCA explains that, to avoid double reporting, future reporting will be wrapped into its reporting against the FCA Strategy. The outcomes and workplans under the Strategy now fit within the wider FCA Strategy and align to its Public Commitments.<br>Over the last couple of years, the FCA has focused on improving standards across the sector, tackling problem firms and bad actors in the areas they have seen the most consumer harm. Under HM Treasury's (HMT's) Smarter Regulatory Framework (SRF), the FCA will have increased rule-making powers over areas that currently sit within retained EU law. This gives them the opportunity to build on the work done to improve standards and develop a more cohesive regulatory framework for the mainstream investment market that delivers good outcomes for consumers.<br>Alongside this update, the FCA are also publishing their joint review of the Advice Guidance Boundary Review - proposals for closing the advice gap with HM Treasury, which sets out potential options for reform to create an environment where consumers can get the help and support they need. They invite feedback on this paper. |
| ***When does it take effect?***<br>N/A |
| ***What should firms be thinking about?***<br>Firms should consider the work planned by the FCA over the next 12 months and use these to inform their assurance activities. |

# Regulatory round up for February 2024

| General |
|---|
| **CP 1/24 Financial Services Compensation Scheme - Management Expenses Levy Limit 2024/25** |
| The Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) have jointly issued a consultation paper on proposals for the Management Expenses Levy Limit (MELL) for the Financial Services Compensation Scheme (FSCS). |
| ***What firms are impacted?***<br><br>All PRA and FCA authorised firms, who fund the FSCS through levies. |
| ***Summary of the regulatory update***<br><br>The MELL covers the FSCS's costs of operating the UK's statutory compensation scheme. The proposed MELL is £108.1 million for 2024/25, consisting of a management expenses budget of £103.1 million and an unlevied reserve of £5 million. The proposed MELL would apply from Monday 1 April 2024, the start of the FSCS's financial year, to Monday 31 March 2025. This is a reduction of £1.7 million from the 23/24 MELL of £109.8 million. The FCA and PRA invite responses on the proposals set out in this consultation.<br><br>In carrying out their policy making functions, both the PRA and FCA are required to comply with several legal obligations. The analysis in this CP explains how the proposals have had regard to the most significant matters, including an explanation of the ways in which having regard to these matters has affected the proposals.<br><br>This CP is relevant to all PRA and FCA authorised firms, who fund the FSCS through levies, but contains no material or direct relevance to retail financial services consumers or consumer groups upon which they might need to act. As costs to authorised firms may be passed on to consumers in the form of higher prices, consumers may indirectly contribute to part of the FSCS levies. However, an efficient and adequately funded compensation scheme is beneficial to all consumers as it helps secure an appropriate degree of protection for consumers of financial services firms and promotes the stability of, and confidence in, the UK financial system. |
| ***When does it take effect?***<br>The proposed MELL would apply from 1 April 2024 – 31 March 2025. |
| ***What should firms be thinking about?***<br><br>If firms wish to provide comments, it should be noted that these must be submitted by **12 February**. |

# Regulatory round up for February 2024

## General

**Overseas Funds Regime: UK's Equivalence Assessment of the EEA states**

In a statement by the Economic Secretary to the Treasury, it was confirmed that the UK Government has found EEA states, including the EU members states, equivalent under the OFR.

***What firms are impacted?***

Fund managers of EU based funds

***Summary of the regulatory update***

In December 2023, the FCA published its consultation setting out how overseas funds (schemes) will be able to be recognised in future, if the UK Government decides to make any equivalence determinations under the Overseas Funds Regime (OFR) in respect of any jurisdiction. The OFR will allow for a more streamlined process for overseas investment funds to be sold to UK investors.

Now the UK Government has confirmed in a statement that the EEA has been deemed an equivalent jurisdiction. The statement also confirms that:

- This equivalence decision will apply to UCITS funds but not Money Market Funds (MMF)
- This decision will be enacted via secondary legislation in due course
- The Government does not intend to require funds assessed to comply with any additional UK requirements; and
- The government will consult subsequently whether broaden the scope of the Sustainability Disclosure Requirements (SDR) to include funds recognised under the OFR.

***When does it take effect?***

The statement was made on 30 January 2024.

***What should firms be thinking about?***

Impacted firms should consider the Government's position and contribute to the open consultation as required.

FOR MORE INFORMATION:

Richard Barnwell

+44 (0)77 1721 4818
richard.barnwell@bdo.co.uk

Osita Egbubine

+44 (0)78 2389 8762
osita.egbubine@bdo.co.uk

Lynne Cooper

+44 (0)78 3197 3356
lynne.cooper@bdo.co.uk



www.bdo.co.uk

XXXXXXX