## INTERNAL AUDIT SUPPORT

# INVESTMENT & WEALTH MANAGEMENT UPDATE

November 2022

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# BDO FS INTERNAL AUDIT CONTACT POINTS

**BDO's Investment and Wealth Management Update summarises the key regulatory developments and emerging business risks relevant for all designated investment firms and wealth managers.**

Our FS Advisory Services team are working with more than 60 investment and wealth management firms, including platform providers and administrators, as internal auditors and advisors, giving us a broad perspective on the issues facing the sector. We have aggregated insights from our in-house research, client base, the Regulators and professional bodies, including the Chartered Institute of Internal Auditors (CIIA), to support your audit plans 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.

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# ESG DISCLOSURES: FCA PROPOSES NEW RULES TO TACKLE GREENWASHING

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## ▶ All regulated firms should tackle greenwashing according to the FCA

On 25 October 2022, the FCA published a Consultation Paper (FCA CP 22/20) regarding sustainability disclosure requirements (SDR) and investment labels. With the proposed rules, the FCA is seeking to clamp down on greenwashing, with a package of new measures including investment product sustainability labels and restrictions on how terms like 'ESG', 'green' or 'sustainable' labels can be used.

This consultation was delayed from Q2 this year and so eagerly anticipated by the sector.

## ▶ Who will this impact?

- The new greenwashing rule will apply to all regulated firms in relation to all products and services; however the 'initial' focus is on investment firms and the new rules are due to come into force on 30 June 2024, one year after the publication of the final rules, subject to consultation feedback.
- The disclosure and labelling requirements will apply to investment firms, advisers and distributors of products, which were initially missing from the proposals in the 2021 FCA Discussion Paper (FCA DP 21/4).
- Not only authorised funds are in scope. Unauthorised funds, including investment trusts and some portfolio management services, are to be covered by the proposed rules.

## ▶ What are the consultation key components?

The proposals for consultation centre around two key components: sustainability disclosure requirements and sustainable investment labels.

- The sustainability disclosure requirements mean certain financial services firms will need to report on their sustainability risks, opportunities and impacts and build on existing frameworks, such as the Taskforce on Climate-related Financial Disclosures (TCFD) and the forthcoming UK Green taxonomy, but also incorporate wider sustainability matters other than the environment;
- The proposed sustainable investment labels related to sustainability credentials will need to be applied to certain investment products.

## ▶ What is the consultation paper proposing to introduce?

The FCA's proposal covers the following key areas:

- A general anti-greenwashing rule that will apply to all regulated firms to ensure that sustainability-related claims must be clear, fair and not misleading;
- Sustainable investment product labels to give consumers the confidence to choose the right products for them;
- Restrictions on how sustainability-related terms such as 'ESG', 'green' or 'sustainable' can be used in product names and marketing for products which don't qualify for the sustainable investment labels;
- Consumer-facing disclosures that will help consumers understand the key sustainability-related features of an investment product and also more detailed disclosures, suitable for institutional investors or retail investors that want to know more;
- Requirements for distributors of products, such as investment platforms, to ensure that the labels and consumer-facing disclosures are accessible and clear to consumers.

## ▶ What is next?

- The FCA is seeking responses to the consultation from across the financial services sector, as well as other interested parties, by 25 January 2023 with a view to publishing final rules by the end of the first half of 2023.
- The CP 22/20 refers to wider developments such as the Government's Roadmap to sustainable investing, Task-force on Climate-Related Financial Disclosures (TCFD) implementation roadmap, and International Sustainability Standards Board (ISSB) framework, thus whilst these rules apply to investment and asset managers more specifically, there is a clear indication that the scope of sustainability regulation will be broadened in the coming years.
- the FCA intends to follow up with a separate consultation in due course on how the proposals in their CP may be applied in respect of overseas funds.

## ▶ What should Internal Audit teams be thinking about?

With this in mind, Internal audit teams should:

- ensure they understand their firm's positioning on ESG;
- consider the risks of deliberate or accidental greenwashing, and make sure they understand the control arrangements over determining the firm's disclosures and claims being made within external reporting;
- explore the extent of assurance required over the firm's data and reporting with their Audit Committees.

# A NEW CORPORATE GOVERNANCE CODE


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## ► Background

Governance and Board Effectiveness has been an increased are of focus and scrutiny for regulators in recent years. The Financial Reporting Council ("FRC") has recently published its Position Paper, "Restoring Trust in Audit and Corporate Governance", that outlines its next steps towards strengthening the Audit and Corporate Governance framework within UK audit and corporate firms.

The Paper follows on from the Government's Response to the consultation on enhancing the UK's Corporate Governance, Corporate Reporting and Audit Systems.

## ► A revised Corporate Governance Code

The FRC has noted that it intends for the revised Corporate Governance Code ("CGC") to be implemented from "periods commencing on or after 1 January 2024" and will consult on the Code and supporting material from Q1 2023.

As such, it is paramount that Internal Audit teams within affected firms start to consider the implications of the revised Code and plan accordingly.

Firms that fall under the FCA Listing Rules must adhere to the Code as a requirement and will, therefore, have to adhere to the proposed changes by 1 January 2024. Other financial services firms may chose to adhere to the CGC requirements and guidance as a means of best practice.

## ► What are the key new changes and requirements?

The CGC will remain principle-based and flexible, but the key enhancements will include:

- The need for a framework of "prudent and effective controls to provide a more stronger basis for reporting on and evidencing the effectiveness of internal controls" for end of year reporting;
- Revisions to "the wider responsibilities of the Board and Audit Committee for expanded Sustainability and ESG reporting" including the requirement for improved assurance in this area;
- To enhance existing CGC provisions where reporting is "weaker" as outlined in the FRC's Creating Positive Culture report (December 2021);
- Adding a provision for boards to consider how the audit tendering process addresses the need to expand market diversity in audit services; and
- **The need for post-implementation governance internal audit reviews to provide assurance that the revised Corporate Governance Code has been adequately implemented.**

## ► What should Internal Audit teams be thinking about?

The proposed changes cover a broad spectrum of governance arrangements and, as such, it may be beneficial for Internal Audit teams to consider the impact of the CGC as part of evaluating the firm's overall governance structure per Performance Standard 2110 (Governance).

Governance arrangements are expected to be appropriate for the "*nature, size and complexity*" of a firm's activities and business model (FCA Handbook, SYSC 3.1.1R). This can often be an elusive term, but key considerations for Internal Audit teams include:

- Are all governance arrangements clearly documented so that employees could outline the relevant reporting lines if questioned?
- Does the firm's current suite of governance documentation, including organisational charts, Management Responsibilities Maps ("MRM"), role and responsibilities descriptions and committee/board Terms of Reference ("TORs"), reflect the current allocation of responsibilities and approval processes currently in practice?
- Are there any potential conflicts of interest or "bottlenecks" within the current governance structure? For example, a lack of independent challenge within key control areas such as Risk and Compliance, remuneration and incentive arrangements or strategic business decisions?
- Are there any "key person risks" where sufficient resilience arrangements and succession planning have not been implemented?

## ► Governance controls – design adequacy vs. operating effectiveness

In addition, whilst control processes, such as organisational structures, may appear to conform with established policies and procedures, this does not necessarily mean that they are operating effectively – i.e., control design may be adequate, but controls may not be operating effectively.

As such, whilst assessing the design of governance arrangements and the underlying framework, internal audit teams should consider conducting effectiveness assessments. These assessments may be in the form of:

- board effectiveness reviews;
- testing of the reporting and escalation mechanisms;
- gaining insights from employees around key issues, e.g. firm culture surveys.

# ECONOMIC CRIME UPDATE FCA MARKETWATCH 70: TRANSACTION REPORTING

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## FCA Market Watch 70

- On 3 October 2022, the FCA published its latest Market Watch newsletter in which it summarised its recent observations from its supervisory engagements with MiFID-compliant firms.
- This periodic newsletter, and summary of the FCA's findings, is relevant for designated investment firms who undertake investment activities and services, including trading activities through regulated trading venues.
- The main areas of focus within Market Watch 70 are summarised below.

## Transaction Reporting

Transaction Reporting from MiFID compliant firms is a key tool for the FCA to detect, investigate and prevent market abuse; therefore, the quality of data underlying a firm's transaction reporting is of critical importance. Firms' regular use of the FCA's Market Data Processor (MDP), to facilitate reporting, is a requirement within the regulatory technical standards (RTS 22). Key issues recently identified by the FCA include:

- Firms not conducting sufficient checks on the data underlying their transaction reporting, i.e., the volume of MDP use for reporting purposes has increased steadily since MiFID II was implemented, but the volume of breach notifications has kept almost stagnant;
- The variable levels of information included in the breach notifications. Reporting firms in some cases have provided limited details and unhelpful references to proprietary reporting systems or processes.

## National Identifiers

National Identifiers, to confirm the nationality of natural persons in transaction reports, is an obligation and all national identifiers can be found within Annex II of RTS 22. Despite repeated warnings from the FCA, firms have been found failing to conduct sufficient due diligence when onboarding clients to obtain the relevant national identifiers.

The issue is 'particularly common' amongst firms offering services to retail clients electronically, such as via mobile-based applications.

## Principal Firms (Appointed Representatives being identified in reports)

The FCA have highlighted confusion from Appointed Representatives (AR) being identified in transaction reports. For transaction reporting purposes, the FCA view an AR as its principal firm. This means that when a transaction is executed by an AR providing the investment service for a principal firm that is subject to transaction reporting obligations, the principal firm should be identified, not the AR.

## Systems and Controls

The FCA also re-emphasised its expectations for the systems and controls of trading venues and systemic internalisers (SI):

- **Identification of issues**: trading venues and SIs should have arrangements in place to enable them to identify incomplete or inaccurate instrument reference data. These arrangements are required by Article 6(2) of RTS 23.
- **Review of MDP feedback**: trading venues and SIs should ensure they have procedures in place to review feedback files, including any warning messages received, which notify the submitting entity that its record differs from the master record used to validate transaction reports. These procedures should include investigating why records or files have been rejected. Submitting entities should not amend their reference data to match the master record without first confirming its accuracy.
- **Regulatory reporting**: where a trading venue or SI identifies incomplete or inaccurate instrument reference data in its submissions, the FCA expects to be notified promptly through the submission of an instrument reference data errors and omission notification form.

## What should Internal Audit teams be thinking about?

- **Risk Assessments:** the quality, and overall clarity, of information submitted to the FCA appears to be a significant risk. Risk mitigation activities should include sufficient oversight over the production, review and submission of transaction data, as well as regular testing of high-risk processes such as breach notifications. Regularly challenge your regulatory reporting teams to the reasonableness test: "would our reporting make sense to a reasonably informed person outside of our walls?"
- **Policies and procedures:** are these clear and up to date with FCA's Market Watch findings? What system of staff training is in place to ensure transaction reporting policies and procedures are understood, followed and its compliance monitored such that any deviations to controls are flagged as soon as possible? Inappropriate risk assessments of reporting processes tend to focus disproportionately on the IT / platform issues (especially given the quantifiable monetary impact to the firm's resources); however, often, the root cause stems from staff being under-trained, under-resourced or mismanaged to properly fulfil reporting processes (i.e. operating effectiveness tends to trump design adequacy as the key issue).
- **Outsourced reporting activities**: issues driven by third-party service providers remain the accountability of the firm and outsourced regulatory reporting, wherever applicable, should feature as a high-risk area within the audit plan.

# A ROUNDUP FROM THE REGULATORS

| REGULATOR | DATE | DOCUMENT | WHAT'S NEW? |
|---|---|---|---|
| BoE | 19/10/2022 | Speech | “Decentralised” Finance: Get up, Stand up! Carolyn Wilkins, FPC, encourages the crypto industry to build best practices in governance, codes of conduct, and set high expectations for transparency |
| FCA | 14/10/2022 | Update | An update from the FCA to address Consumer Duty related queries received from in-scope firms |
| PRA | 12/10/2022 | CP12/22 | Proposals to better manage the risks from contingent leverage which will affect the ICAAP and future reporting of leverage |
| FCA/PRA/BoE | 11/10/2022 | DP5/22 | Discussion paper from the Regulators to consider the challenges associated with the use and regulation of Artificial Intelligence |
| FCA | 03/10/2022 | CP22/19 | Creation of a baseline financial resilience regulatory return relevant for FCA-solo regulated firms |
| FCA | 03/10/2022 | Market Watch 70 | FCA's most recent observations on the transaction reporting and instrument reference data regimes |

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