

A woman with short brown hair, wearing a red collared shirt, is shown from the chest up. She is looking upwards and to the right with a thoughtful expression, holding a pair of thin-rimmed glasses in her right hand, which is resting on her chin. She is wearing a gold ring on her right ring finger and small gold hoop earrings. The background is dark grey. On the left side of the image, there are two vertical red bars: one at the top and one at the bottom, both with a slight diagonal cut at the top and bottom respectively.

INTERNAL AUDIT SUPPORT

INVESTMENT AND WEALTH MANAGEMENT

July 2023

BDO FS INTERNAL AUDIT CONTACT POINTS

We hope our insights during the year have supported your Internal Audit activities, and we look forward to our next edition, to be published in September 2023, where we will continue to explore the key risks and regulatory developments with which to appropriately evolve annual plans.

Until then, from all of us at BDO, we wish you a very enjoyable summer season!

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 July have for our future editions.



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01




2023 REGULATORY PRIORITIES





2023 REGULATORY PRIORITIES

FCA 'Dear CEO' letter to Asset Managers

 REGULATOR	 SECTOR RISK	 FCA FOCUS
Product Governance	<p>That the quality and value of product offerings, or the quality of communications with customers, do not deliver good outcomes for consumers or meet their needs, e.g., because the product carries excessive costs and charges, is not designed with the target audience in mind, or is distributed to the wrong type of investor. We have covered this subject in our April pack.</p>	<p>FCA's expectation is that firms achieve the Consumer Duty requirements when they determine or have a material influence over retail customer outcomes. The regulator will follow-up on its 2021 Assessment of Value review findings and seek to identify outlier firms. It will also conduct another review in 2024 to assess the embeddedness of the Duty, with a focus on Price and Value.</p>
Environmental, Social and Governance (ESG) and Sustainable Investing	<p>Risks exist that some claims about ESG and sustainable investing are misleading or inaccurate. Inaccurate or misleading information July negatively impact the integrity of the UK financial disclosure regime and is likely to harm investment confidence. Our monthly packs provide regular coverage on climate change financial risk developments - including this month (see below).</p>	<p>The governance structures that oversee ESG and stewardship considerations, including whether firms deliver on the claims made in their communications with investors, and outlier firms that have been identified in previous supervisory activities or other ongoing surveillance. The regulator is keen to see that firms ensure their governance bodies are appropriately structured to oversee and review management information about product development, ESG and sustainability integration in investment processes, third-party and proprietary ESG information providers, and other ESG and sustainability claims made by authorised firms.</p>
Product Liquidity Management	<p>Open ended funds can have a liquidity mismatch between the terms at which investors can redeem and the time needed to liquidate fund assets to meet the redemption request. A variety of market and pricing shocks have caused liquidity issues for Liability Driven Investment portfolios, property funds, and money market funds. Firms have tools available to improve the quality of their liquidity risk management, but we have concerns that they July not always oversee them correctly or use them consistently. We have covered this subject in our April pack.</p>	<p>The FCA is working with the Bank of England, and other regulators internationally, to strengthen resilience of money market funds, funds with significant liquidity mismatches, and transmission of risk from the non-bank financial sector to the wider market. The regulator is also in the process of completing a liquidity management multi-firm (thematic) review.</p>



2023 REGULATORY PRIORITIES

FCA 'Dear CEO' letter to Asset Managers



REGULATOR

**Investment
in Operations
and Resilience**



SECTOR RISK

Underinvestment in operations can lead to service disruption or failure, with consequential loss to investors and detriment to markets. Increased market volatility or stress July heighten the impact of disruption on consumer outcomes and market integrity. Poor investment in operations can hamper innovation, reduce efficiency and increase cost, and can result in service decline for investors. It July also result in business disruptions, or lead to vulnerabilities that can be exploited to control systems or inappropriately transfer information.

We have covered this subject in our [March pack](#).



FCA FOCUS

The FCA will complete a range of proactive programmes to monitor and test Asset Managers' ability to meet operational resilience regulatory requirements. Firms July be selected for further regulatory review, including the FCA's use of its cyber and operational resilience assessment tools, as well as intelligence-led penetration testing scheme (CBEST).

Financial Resilience

Disorderly firm failure has the potential to cause significant material detriment to consumers and markets.

We will be covering this topic in our September 2023 pack.

The regulator will continue to assess firms' prudential health using internal and external data sources and, where necessary, will conduct targeted monitoring visits. Where firms are failing, or are likely to fail, the FCA will take appropriate actions to minimise the harm from failure. In H1 2023, the FCA aims to publish initial observations on firms' implementation of the IFPR requirements, which should be considered by firms when reviewing and strengthening processes.

02

MEET THE TEAM



CHRIS BELLAIRE
Partner, Financial Services Advisory





MEET THE TEAM

Each month, we shed more light on our FS Internal Audit practitioners so that we can get to know the person behind the practice in 10 questions. This month, we get properly introduced to Chris Bellairs.

1. What has been your career leading into BDO?

My career started by accident when I took a holiday job with a Lloyd's syndicate. My job was as "general dogsbody to the executive team" - a great introduction to governance and the City and included being the liaison person for their external auditors.

An ACA qualification after university seemed a logical step (which deferred making a real decision about a job for another 3 years). I always planned to move into industry after qualifying, but plans change.

During my early career I sat within the external audit team but was fortunate to get lots of special assignments, these included acquisition due diligence, stock exchange listings and investigations into fraud and malpractice. From these non-external audit assignments, my love of all things internal audit was born.

Roll forward to 2012 and I had established a successful and growing Investment Management Internal Audit practice for a Big 4 firm. At this point I realised that a lot of my wider FS sector experience was not being used and an opportunity arose to move to BDO, hence my current role now almost 10 years later.

2. Describe your role in the FS Internal Audit team?

My role is threefold:

- ▶ As FS clients and markets leader, I am responsible for driving profitable and sustainable growth across our advisory business. I am passionate about working with the right clients in partnership for the long-term and bringing the best of BDO to them.
- ▶ Second, I am the engagement leader and Head of Internal Audit for a number of firms, spanning Banking, Wealth & Asset Management, Insurance and Pensions sub-sectors.

This may seem like I'm a jack of all sectors, but as Head of IA, I am responsible for ensuring the appropriately skilled people in our business carry out the underlying work and I focus on delivering quality and maintaining compliance with the IIA standards, FS CIIA Code and client expectations.

- ▶ Finally, and to me most importantly, I am a coach and mentor to the team. Helping our teams succeed, nurturing talent and supporting careers over the long term is something I truly enjoy - my door is always open and I love chatting through goals and aspirations, and not just those that are work-related.

3. What's the most interesting thing you're working on right now?

The BDO way and how we put our clients at the centre of everything we do. I am working across our advisory business, learning about how our specialist teams approach their clients, capturing the best practices and thinking of ways to collaborate across teams even more. We are all on a journey, and it's exciting working with such talented people, sharing ideas and making new relationships. Over the next year, our colleagues will start to see and feel the enhancements in our approach at some of our clients, learn more about what the rest of the firm can do and build upon our knowledge base and contacts across BDO's Advisory practice.

4. Best thing about being part of the Internal Audit Team?

The diversity of what we do and who we meet. Being part of our vibrant and passionate team that helps such a broad range of clients is brilliant. Everyone has a common purpose, and our longstanding clients feel this come through in our work every audit cycle.

5. What drives you to do what you do?

I enjoy helping people and I'm good at finding practical solutions to things. I am always amazed when I reflect back (especially at this time of year during our appraisal season) just how much life experience I gain each year.

6. What's something that has surprised you about your Internal Audit career path?

You never stopped learning. Every day I learn something new, and the breadth of learning is truly amazing. Whilst it may seem I do the same thing year-on-year, no two years have ever been the same and I never get bored of what I do.

7. What's the best piece of professional advice you've ever received?

Be curious and focus on the person not the task. You will always achieve a deeper, more meaningful understanding if you really understand the people involved.

8. How do you see internal audit changing over the next few years?

Automation and data monitoring will replace some of the more mundane internal audit tasks, allowing internal audit teams to focus on the interpretation and challenge to those charged with governance. The type of reviews is already changing to a much more thematic approach, and this will mean internal audit can start to challenge at a much more strategic level rather than just processes. We will all need to up-skill to remain relevant.

9. What is your favourite thing to do when you're not working?

Children, gardening, and Formula 1. Five boys aged 2-15 means I'm a constant taxi service and sports match supporter which I love! Mowing the lawn tends to be my down time and F1 is currently the poor cousin which I watch on catch-up in any spare moments.

10. If you were stranded on a desert island, what three items would you want to have with you?

My wife Charlotte, a hammock and a yacht (I think I would suffer island fever very quickly)!

03

ESG UPDATE

ESG AND SUSTAINABILITY IN THE NEW CORPORATE GOVERNANCE CODE



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ESG AND SUSTAINABILITY IN THE NEW CORPORATE GOVERNANCE CODE

The Financial Reporting Council (FRC) has recently launched a public consultation (in May 2023) on revisions to the Corporate Governance Code ('the Code'), which follow the UK Government's response to the [White Paper](#) published in July 2022 'Restoring Trust in Audit and Corporate Governance'. Comments on the questions set out in the consultation document are to be submitted by Wednesday 13 September 2023.

Whilst the Code is applicable to premium listed companies, it demonstrates a direction of travel for sustainability expectations of the financial regulators and the need for more robust frameworks for effective risk management and internal controls around, amongst other matters, how firms manage sustainability and environmental, social and governance (ESG) issues. We explore, below, the key changes to the Code.

Wider responsibilities of the Board and Audit Committee for expanded sustainability and ESG reporting

Boards have responsibility for sustainability and ESG strategy. The FRC's proposal calls on Boards to consider their longer-term approach to introducing ESG expertise to be able to form an independent judgement in this area. In addition, Provision 1 is expanded to make it clear that ESG matters, including climate ambitions and transition plans, should be considered in assessing the basis on which the company generates and preserves value over the long-term.

Whilst most companies are already reporting on governance of climate change within their TCFD disclosures, the proposal is more specific as it covers reporting on climate ambitions and transition planning, in the context of an organisation's strategy, as well as the surrounding governance arrangements.

The changes aim to encourage companies to report on the effectiveness of embedding sustainability and culture in-line with the findings of their 2021 report: '[Creating Positive Culture - Opportunities and Challenges](#)'.

In addition, Audit Committees will be allocated responsibilities to make them consider wider sustainability-related matters. The Audit Committee, which has experience in overseeing Firm policy and frameworks, will be expected to oversee ESG disclosures, controls, processes, and assurance. Therefore, the remit of Audit Committees will be expanded to include narrative reporting, including sustainability reporting, and where appropriate, ESG metrics, where such matters are not reserved for the Board. Furthermore, the Audit Committee will be expected to publish, within the annual report, on the significant issues that it considered relating to narrative reporting, including sustainability matters, how these issues were addressed and, the outcomes of any assurance of ESG metrics and other sustainability matters commissioned by the Board.

Wider diversity and inclusion reporting

An amendment is proposed to Principle J (Principle I in the new Code) to include a reference to inclusion, and to give equal weight to all protected and non-protected characteristics, to encourage companies to consider diversity beyond gender and ethnicity. This will require firms to capture and report on a wider set of diversity characteristics and in general to improve reporting on diversity, particularly in relation to the success of their diversity policy initiatives (in Section 3). This includes requiring a more transparent approach to reporting on succession planning and senior appointments as this was an area identified with poor reporting.

Addressing diversity is not new to the code, as the importance of diversity and inclusion in the composition of the Board, executive management and in succession planning, is already highlighted in current Principles J and L, and Provisions 17, 19 and 23.

However, the intention is to make the code more aligned to the [FCA's Policy Statement 22/3](#) on diversity and inclusion for company Boards and Executive Management. The FRC's aim is to improve transparency to understand the role of any targets or initiatives companies have chosen to use in order to achieve greater diversity and inclusion within their Firm.

The new Code also has provisions to improve the functioning of comply-or-explain where reporting is currently weaker, taking account of recently published FRC research, thematic feedback and reports - this includes ESG reporting.

ESG AND SUSTAINABILITY IN THE NEW CORPORATE GOVERNANCE CODE

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Audit Committees constitute a fundamental link between a company's shareholders, owners and investors and the functioning of the internal controls and they should review the extent to which the responsibilities of their Boards and sub-committees, including the Audit Committee, have been appropriately defined and are being implemented effectively.

In addition, internal audit can oversee that sustainability metrics and ESG information reported to stakeholders is appropriate to support investment and stewardship decisions.

With regard to D&I, IA teams are appropriately placed to evaluate the "Tone from the top". It is essential to have senior management making it clear that D&I is a central part of the firm's strategy and fully supportive of developing the firm's D&I maturity.

Examples of successful D&I reviews have included the CEO, or Chairperson, taking on the role as the D&I lead for the firm so that the subject is kept uppermost on the corporate agenda. This is most poignant for firms at the early stages of their D&I development in addressing any scepticism from within the executive, e.g., questions over the shareholder value from pursuing a D&I agenda amidst competing priorities. While this may appear to be an obvious consideration, this is likely the most challenging as it is a sensitive topic and, very likely, a challenge for senior management to be "comfortable with the uncomfortable" discussions that lay ahead.

How can we help?

The ESG landscape is evolving at a rapid pace, and this requires additional resources or guidance to keep up with the pace. If you have any questions, please contact a member of [BDO's Financial Services ESG team](#), we will be happy to talk to you and discuss our and your views on what to watch out for in 2023.



04

QUALITY MATTERS

PART 4

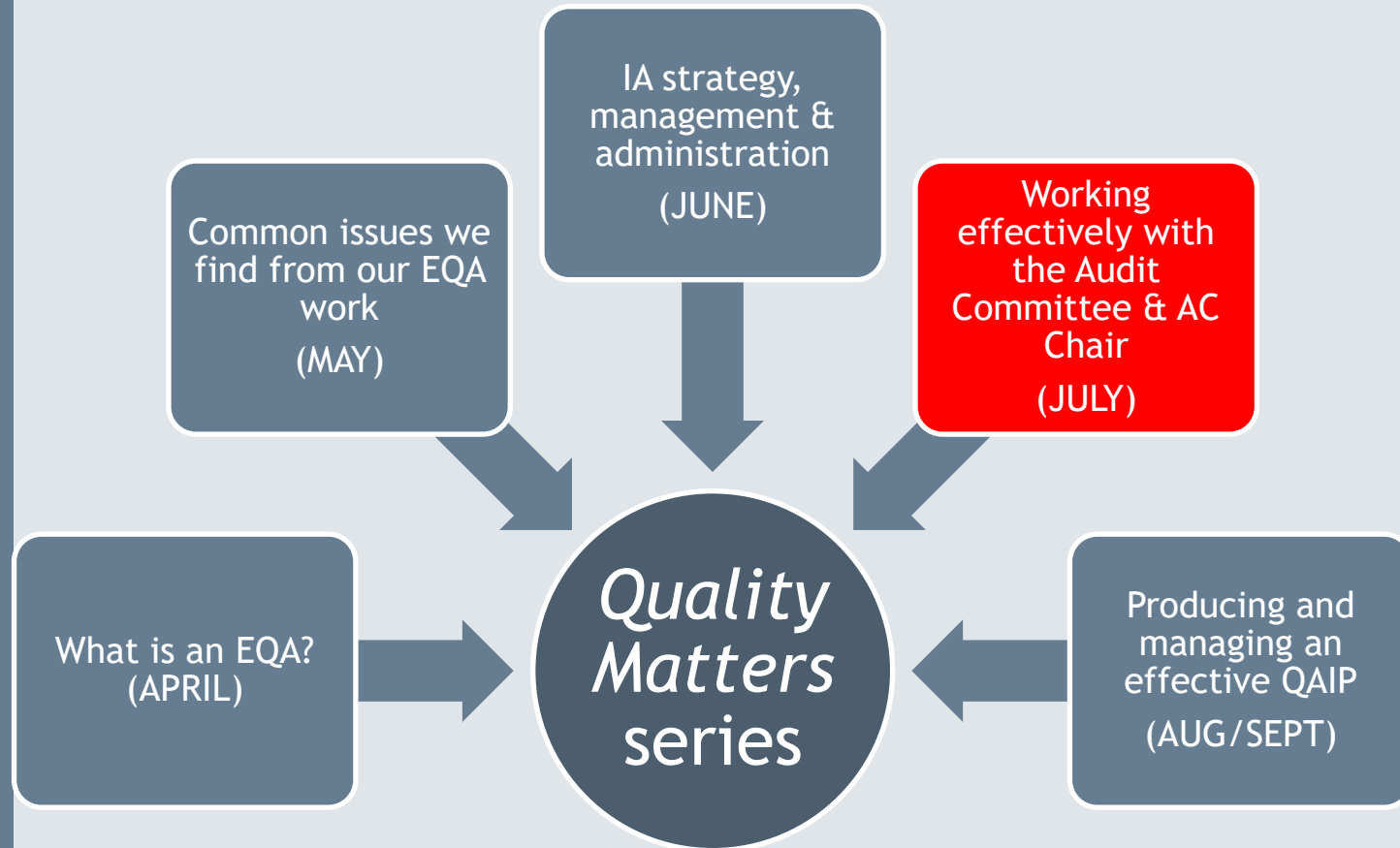
WORKING EFFECTIVELY WITH THE AUDIT COMMITTEE & AC CHAIR



SAM PATEL
Partner



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Associate Director





QUALITY MATTERS - PART 4

Working effectively with the Audit Committee and AC Chair

In our [June pack](#), we explored the common issues regarding Internal Audit (IA) strategy, management and administration which we've observed from our External Quality Assessments (EQA), as well as insights we've gathered from observing some simple good practices missing within strategy setting and the key administrative matters, such as demonstrating independence.

This month, we delve deeper into the dynamic relationship between the Head of Internal Audit (HoIA) and Audit Committee (AC), especially the AC Chair, that we've typically picked up on from our EQA engagements.

If we start from the presumption that maintaining an open, transparent, constructive and supportive relationship between the HoIA and AC Chair is vital to ensure that the IA activity can fulfil its mission, then our experience from EQA engagements has helped us identify the common "red flags" which suggest that the HoIA / AC Chair relationship is proving ineffective, or inoperable, as well as what good practices, rooted in the Standards and FS Code, can help embed an effective working relationship between the HoIA with the AC and its Chair.

RECRUITMENT, REMUNERATION AND REVIEWS

The AC must make effective use of the IA function in providing the Senior Management and Board assurance on risk management, governance and internal controls. With this in mind, the appointed HoIA will report directly to the AC and be entrusted by the AC to lead delivery of a comprehensive audit plan of assurance and consulting activities to add value to the firm, co-ordinated with all other assurance providers, and kept within a defined (hard fought) budget.

The AC, based on the HoIA's performance, will also be the body that decides on the HoIA's re-appointment, remuneration and, if circumstances prove dire, shows them the door. Therefore, well before the Internal Audit Charter is drafted, the recruitment for a HoIA absolutely needs to be led by the AC with the AC Chair positioned as the principal point of contact for the recruitment process, i.e., retaining a professional recruiter, conducting informal enquiries about seasoned audit leaders, shortlisting candidates, conducting interviews, etc. This firmly lines up with the FS Code's requirement (Section E, part 20).

So what happens when the HoIA's recruitment and appointment is not led by the AC? A mixed bag of outcomes.

At the challenging end of the spectrum, the AC members may have had a very distinct ideal candidate for the type of risks present within the firm, the technical expertise required over the course of 5 years or more (e.g. the AC knows that a merger is on the horizon, so the AC Chair may seek a HoIA with proven experience in assuring large scale transformation programmes - a subject we covered in detail in our [June pack](#)), or a complementary set of skills to the CRO so that a comprehensive assurance map is easier to achieve. So if the CEO, or wider Executive, lead the HoIA's recruitment process, the AC may have substantial reservations about the capabilities of the audit executive in addressing what the AC feels are priority risks, as well as doubts over the real motivations behind the recruitment process if it was led by Executives (given they are working to achieve commercial objectives, not necessarily assuring risks and preserving organisational value).

We've seen that a faulty recruitment process is often accompanied by a strained relationship between HoIA and AC, the AC Chair potentially second-guessing rationale for key decisions (given Executive recruited the HoIA) and a continual effort from the HoIA to meet the AC's expectations, which were not incorporated into the candidate's search. Typically, either the AC turns over with new appointees or the HoIA's role at the firm will be short-lived; either way, a HoIA recruited outside of the AC will generally struggle to meet the AC's expectations.

In other scenarios, there could be an embedding period for the AC Chair and HoIA to 'meet in the middle', start to mould each other over the course of audit delivery such that the HoIA is eventually groomed into the ideal candidate to meet the AC's expectations. This takes considerable patience and brinksmanship to effectively 'keep at the job' until the HoIA feels they're thinking and moving in sync with the AC, and the AC feels satisfied that the incumbent HoIA is worthy of the role.



QUALITY MATTERS - PART 4

Working effectively with the Audit Committee and AC Chair

As the AC Chair will be the HoIA's key accountable Board member, the HoIA's remuneration should also be set by the AC - why is this important? Two key reasons:

- ▶ **Objectives and performance review** - more on that below;
- ▶ **Incentives and benchmarking** - the AC would want to ensure that the HoIA's remuneration structure appropriately incentivises the HoIA to achieve planned audit delivery (e.g., KPIs) and, overall, add value (consulting activities, technical support, facilitation of key programmes, etc) to the organisation. This is clearly set out in the FS Code too (Section E, part 22). The AC is also best placed to ensure the HoIA remuneration is appropriately scaled as the AC Non-Executive Directors (NEDs) are themselves tasked with ensuring that an effective assurance framework is in place - the AC and HoIA's incentives are aligned. The CEO and wider Executive would be conflicted given their objectives and incentivisation structure would be tuned into value maximisation - a HoIA, being a cost centre, will likely be squeezed, if entirely left to a CEO's decision-making, to the minimum level possible and attract inexperienced (or ineffective) audit executives. You pay peanuts, etc etc.

We've also seen that remuneration for a HoIA may also typically sit on a different pay scale to the rest of the organisation to ensure that skilled and experienced control function practitioners are drawn to the role. Most AC members, or at least the AC Chair, were auditors (either external, internal or both during an established career) and, therefore, have an intuitive feel from industry events, informal networks and their private discussion with recruiters in the audit sector as to "what good looks like" proportionate to the scale of business risks and expected challenges in providing assurance for the firm.

Once the recruitment process and remuneration discussion has been completed, the AC needs to set the HoIA objectives and establish at the outset a clear appraisal process that ties in with the Internal Audit Charter once agreed. Not only does this help demonstrate conformance to AS 1111 ("Direct Interaction with the Board"), it also ensures, from our assessment experience, that the AC Chair is properly tracking the HoIA's performance on the critical soft skills he/she will need to be effective in the role, such as:

- ▶ Is the HoIA maintaining independence? Do they provide constructive, evidence-based, challenge to the business?

- ▶ Does the HoIA have the gravitas, credibility and career experience to hold senior leaders accountable, engage with them as a peer and demonstrably add value to their business projects?

- ▶ Is the HoIA an audit leader? Are they bringing the IA function with them?

PLANNING PROCESS

The audit planning process needs to include perspectives from the firm's Chairperson, NEDs - especially the AC - and the firm's Senior Management from the very outset (keep in mind PS 2010 A2. - "Planning").

This seems very intuitive, but we've seen from our EQA assessments where this has not been achieved, leaving a big disconnect between the AC's expectations for assurance and what the HoIA drives forward as (in their mind) a well-considered and coherent audit plan. Such a scenario typically unfolds where we have identified at its root cause a lack of regular 1:1 meetings between the HoIA and AC Chair - if there are no regular catch ups, there is little to no chance that the AC Chair will have the opportunity to voice views from the AC and Board to the HoIA.

So, what happens when the Board's expectations are not considered within audit planning and the AC Chair has no regular meetings with the HoIA?

Firstly, an incoherent plan that fails to accomplish the Mission of Internal Audit (let alone conformance to the Standards and FS Code) and either:

- ▶ a (literal) boardroom battle over what the HoIA has put forward as the audit plan for the coming year / 3-year cycle in the AC meeting, which will inevitably fall short of the Board's expectations. There would also be considerable, heated, discussion that reflects poorly on the HoIA and AC members, not least in front of the Board if the audit plan is presented to the whole Board. Short time left for the HoIA's tenure; or
- ▶ a lacklustre discussion on the audit plan at the AC meeting, attendees effectively 'going through the motions' with no substantive challenge or inspection by the AC members of what has been included and excluded from the audit plan by the HoIA (and why), no enquiries on the role of co-source expertise, collaboration with Risk, Compliance etc. The plan may still get approved on this basis (it does happen in some firms). The tenure for the HoIA is still in jeopardy, but, in this scenario, it's just waiting for a key (unaddressed) risk to materialize so that the AC can apportion blame to the HoIA at the appropriate time.



QUALITY MATTERS - PART 4

Working effectively with the Audit Committee and AC Chair

AUDIT COMMITTEE MEETINGS

With respect to AC meetings, as much as most matters within Internal Audit, nothing should be a surprise.

If there are regular private meetings between the HoIA and AC Chair, then there should be sufficient opportunity to prepare for AC meeting presentations, co-ordinate updates and for the HoIA to be forewarned of the anticipated challenges and technical queries expected from AC members such that the HoIA can prepare some back-pocket notes to address key issues that can pop up. In a sense, we have found from external assessments that effective IA functions typically have an AC Chair and HoIA 'double act':

- ▶ The HoIA is on the ground leading delivery, closing down issues, scanning horizon risks and partnering with business heads; meanwhile
- ▶ The AC Chair is providing appropriate 'air cover' at the Board level, by constructively challenging the HoIA to meet evolving Board expectations, coaching the HoIA's performance as an audit leader and standing by the HoIA's conclusions from reports and assessments (provided they have first withstood the AC's challenge).

The early stages of an EQA involves review of AC packs and meeting minutes. We quickly get a feel for the depth of discussion at AC meetings, cadence for closing actions, the issues raised and, most importantly, the level and sophistication of challenge from the AC to the HoIA's update. We have generally found serious conformance issues when the AC minutes have been found lacking in sufficient detail to evidence the appropriate level of discussions and challenge. Overdue actions, in particular, provide a litmus test on the AC's effectiveness (as much as the HoIA's) - how many questions have been asked by the AC, if any? Have the AC noted in discussion their awareness of delayed reviews, delayed reports, lack of momentum behind overdue actions? These are poignant signs towards the effectiveness of the AC / HoIA relationship and the effectiveness of both AC Chair and HoIA individually in the discharge of their respective roles.

AUDIT COMMITTEE REPORTING

Reporting to the AC must include information relating to significant risk exposures and control issues (PS 2060 - "Reporting to Senior Management and the Board").

While there is an agreed cadence for AC meetings, e.g., quarterly or bi-monthly, there needs to be a direct and open communication channel between the HoIA and AC Chair such that issues that require urgent attention are promptly escalated and reported to the Executive for efficient resolution.

When assessing the regular reporting to the AC, we often come across AC packs prepared by the HoIA which are too voluminous to be useful as a reporting tool. Such packs tend to get into a comfort zone of reporting back to the AC on everything that the IA function has accomplished as opposed to what's important, i.e., the AC can't see the wood for the trees. In assessments where we have seen AC packs that run over 300 pages, with a lack of focus, and papers shared one week before the AC meeting we can confidently determine that the reporting process is not facilitating effective oversight from the AC. The more important insight from our assessment is where (culturally) the problem stems from - the HoIA or an AC that is not reviewing and challenging the audit executive?

When we also assess papers issued by the IA function to other bodies, such as the Exco, Board Risk Committee and other technical committees, we can generally spot a pattern where the same voluminous materials are provided to the different audiences that seek to discuss issues at different depths of detail and would want differing inputs from the IA function (i.e., IA to either monitor, advise, facilitate or assess). It would appear that the IA function has one blunt reporting tool used for different purposes and, thereby, failing to deliver on a big part of where IA could materially add value.

We look forward to sharing the next instalment of our "Quality Matters" series where we explore good practices for producing and managing a Quality Assurance and Improvement Plan based on insights gathered from our EQA and quality assurance work.

05

FINALISED FINANCIAL PROMOTION RULES FOR CRYPTOASSETS



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FINALISED FINANCIAL PROMOTION RULES FOR CRYPTOASSETS

BACKGROUND

The Financial Conduct Authority (FCA) have published final rules governing the marketing of cryptoassets to consumers (PS23/6). The new rules will classify cryptoassets as Restricted mass market Investments, meaning they can be mass-marketed in a limited manner provided that a number of restrictions are first put in place.

A financial promotion is an inducement or invitation to engage in investment activity and must be 'fair, clear and not misleading'. The marketing of cryptoassets falls within this definition of financial promotions and can only be approved by an FCA authorised firm. The new rules follow consultation (FCA CP22/2), published in January 2022, in which the FCA set out its proposals for strengthening its financial promotion rules for high-risk investments, including cryptoassets. Final rules for marketing other high-risk investments were published in August 2022 (FCA PS22/10) to which we assessed and shared our insights [here](#). FCA PS23/6 finalises the policy proposals with the issue of final rules for specifically marketing cryptoassets.

WHAT INSTRUMENTS ARE IN-SCOPE?

The final rules apply to 'qualifying cryptoassets'. Qualifying cryptoassets are defined as any cryptographically secured digital representation of value or contractual rights that is transferable and fungible, but does not include cryptoassets which meet the definition of electronic money, fiat currency (including those that are digitally issued) or an existing controlled investment. Also excluded from the definition are cryptoassets that cannot be transferred or sold in exchange for money or other cryptoassets, except by way of redemption with the issuer.

WHAT FIRMS ARE IMPACTED BY THE NEW RULES?

- ▶ Cryptoasset businesses registered with the FCA
- ▶ Cryptoasset businesses considering FCA registration

- ▶ Overseas cryptoasset firms marketing, or considering marketing, to UK consumers
- ▶ Authorised firms considering communicating or approving cryptoasset financial promotions under s.21 of the FSMA
- ▶ Persons involved in communicating cryptoasset financial promotions to UK consumers, such as intermediaries, on behalf of cryptoasset firms

WHAT FINANCIAL PROMOTIONS ARE WITHIN SCOPE OF THE NEW RULES?

Financial promotions to engage in any of the following controlled activities in relation to qualifying cryptoassets will be brought in under the new rules:

- ▶ Dealing in securities
- ▶ Arranging deals in investments
- ▶ Managing investments
- ▶ Advising on investments
- ▶ Agreeing to carry on specified kinds of activity

As a result of the new rules, there are only now four ways to legally promote cryptoassets to consumers:

- ▶ The promotion is communicated by an authorised person
- ▶ The promotion is communicated by an unauthorised person but it has been approved by an authorised person under s.21 FSMA
- ▶ The promotion is communicated by (or on behalf of) a cryptoasset firm registered with the FCA under the Money Laundering Regulations
- ▶ The promotion is communicated in compliance with the conditions of an exemption within the Financial Promotions Order.





FINALISED FINANCIAL PROMOTION RULES FOR CRYPTOASSETS

WHAT ARE THE FINAL RULES?

The final rules are basically as they were consulted on, albeit with a few minor amendments.

Categorisation of Cryptoassets

PS22/10 finalised three categories for investment products:

- ▶ Readily Realisable securities
- ▶ Restricted Mass Market Investments (RMMIs); and
- ▶ Non-mass market investments (NMMIs).

Cryptoassets will fall within the RMMI category. RMMIs include shares/bonds of non-listed entities and P2P agreements. The restrictions around the marketing of RMMIs will therefore apply to promotions of cryptoassets. The FCA view this approach as striking the right balance between consumer protection and promoting responsible innovation. Further details about RMMIs can also be found from our insights on the subject of “High Risk Investments” from our [April pack](#).

Risk warnings and risk summaries

The common feature of RMMI products is that they are only likely to be appropriate for consumers as a small part of a diversified portfolio and they have characteristics which represent a higher risk to retail investors. This means they should only be accessed when consumers understand the risks involved. Consequently, the risk warning and risk summary provisions for RMMIs have been applied to cryptoasset promotions.

A new risk warning statement has been set out, with the distinguishing feature that it tells customers that there is unlikely to be any protection from the FSCS if something goes wrong. Risk summaries will also need to be tailored to reflect the risks of the cryptoasset being promoted. Changes to the risk summaries will need to be recorded and justifiable.

Incentives to invest

The ban on offering incentives (monetary or non-monetary) to consumers for investing also applies to cryptoasset promotions. The ban on incentives for other RMMIs provides an exemption for shareholder benefits, i.e., products and services produced or provided by the issuer of or borrower under the relevant investment. This shareholder ban has not been extended to cryptoassets due to the inherently programmable nature of cryptoassets and the risk that issuers could drive from arbitraging this rule to impact investors’ decisions.

Cooling-off period

Under RMMI rules, firms are required to wait 24 hours from the time a customer requests to view a direct offer financial promotion (DOFP) to when they can actually provide the DOFP to them. DOFPs are financial promotions which include the manner of response or a form by which response can be made. This cooling-off period will apply to first time investors with a specific firm and not necessarily for each transaction by the customer.

During this period, the firm may conclude its AML/KYC processes. The personalised risk warning pop-up should also be provided prior to the DOFP being provided to the customer.

Client categorisation

DOFPs in relation to RMMIs can only be issued to Restricted, High Net Worth, Self-certified sophisticated or certified sophisticated investors. The same restrictions apply to cryptoassets; however, the self-certified sophisticated investor category does not exist for cryptoassets. This will require the investor to sign a declaration stating that they meet the relevant criteria for their categorisation. These investor declarations will be valid for 12 months only. Firms will, therefore, need to re-categorise customers after the 12-month period has expired.

Appropriateness Assessment

Similar to the requirements for all other RMMIs, firms will be required to assess the cryptoasset as appropriate for the customer before an application or order for the instrument is processed. If the customer fails the assessment a second time, there should be a minimum 24-hour lock out period before they can take the assessment again. The FCA will issue updated guidance on the topics it will expect firms to include as part of the appropriateness assessment.

Record keeping requirements

In-scope firms will be required to maintain records on client categorisation and appropriateness assessments. The rules apply to firms communicating as well as firms approving DOFPs.

WHAT ARE THE RULES FOR FIRMS APPROVING FINANCIAL PROMOTIONS OF CRYPTOASSETS UNDER S.21?

The rules on firms approving the financial promotions of unauthorised entities remain applicable.

The overarching requirement is for approving firms to ensure the promotion of the unauthorised firm is fair, clear and not misleading, particularly in presentation and substance. In relation to the approval of promotions for RMMIs specifically, the rules require approving firms to ensure all such promotions include the details of the approving firm and the date of approval, requiring such firms to have the competence and expertise in the type of investment being promoted, ensuring that there have been no material changes to the disclosures in the promotion, and performing ongoing checks that the appropriateness rules are being followed.

Approving firms will also need to ensure that they are meeting the requirements of the Consumer Duty, for example, defining the target market and that the product is appropriate for the target market, as well as testing and monitoring consumer outcomes.

FINALISED FINANCIAL PROMOTION RULES FOR CRYPTOASSETS

WHEN WILL THE RULES BE IMPLEMENTED?

The rules will go into effect on 8 October 2023. From this date, provisions on risk warnings and cooling-off periods apply to first time investors with the firm seeking access to a DOFP. Client categorisation and appropriateness assessment rules will also apply from this date when a firm wishes to issue a DOFP to an existing customer.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

- ▶ Cryptoasset businesses registered with the FCA under the Money Laundering Regulations are not authorised firms; however, they have a special exemption to be able to approve their own promotions. IA teams will need to ensure that firms have the right systems and controls to comply with these rules before the deadline, including developing suitable appropriateness assessments.
- ▶ Cryptoasset businesses will need to put in place the appropriate policies and procedures for implementing the risk warning, client categorisation and appropriateness assessment rules.
- ▶ For firms which approve financial promotions of unauthorised businesses, IA teams will need to assess whether the senior management team has put in place enhanced monitoring to ensure those businesses have the appropriate controls for communicating the promotions and maintaining appropriate records.
- ▶ These approving firms will also need to ensure their financial promotions approvals processes are included in their Consumer Duty implementation project, with outcomes regularly tested.



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ECONOMIC CRIME UPDATE



DECLAN BIDDULPH
Manager



ECONOMIC CRIME UPDATE

Corporate Criminal Liability for Economic Crime Offenses

The Corporate Criminal Liability for Economic Crime Offenses, published on 15 June, will mean that businesses who commit fraud, money laundering, and bribery will be subject to stricter scrutiny under new Home Office plans.

The proposed reforms, which will form part of the Economic Crime and Corporate Transparency Bill, aim to provide more stringent scope of who can be considered the 'directing mind and will' of a business. The term 'directing mind and will' is generally interpreted to be Board members and/or executive management. However, the proposed reforms will widen this scope to include Senior Management, and therefore, if an individual considered to be in a Senior Management position is to commit an economic crime offence, the company can also be held criminally liable and fined for the offence.

Currently, Regulation 21 of the Money Laundering Regulations ('MLRs') requires relevant persons to carry out screening of the appointed individual who has the responsibility for the relevant person's compliance with the MLRs. Screening is to include an assessment of the skills, knowledge, and expertise of the individual, as well as the conduct and integrity of the individual. With the introduction of proposed reforms, it may be beneficial for Internal Audit teams to consider widening the scope of their assurance over AML screening programmes to other roles considered to be Senior Management.

UK List of High-Risk Third Countries

The MLRs requires relevant persons to apply Enhanced Due Diligence ('EDD') and enhanced ongoing monitoring in relation to circumstances where a person established in a high-risk third country or in relation to any relevant transaction where either of the parties to the transaction is established in a high-risk third country. The UK's list of high-risk third countries is defined within Schedule 3ZA of the MLRs.

As of 27 June, both Cambodia and Morocco were removed from Schedule 3ZA as a result of the February FATF plenary.

With the news from the FATF's June plenary that Cameroon, Croatia, and Vietnam have been placed on the list of FATF's jurisdictions under increased monitoring, it is likely these three jurisdictions will be included in the next update to Schedule 3ZA.

With this in mind, it is vitally important that Internal Audit teams review their country risk assessments to ensure both Cambodia and Morocco are risk assessed appropriately following their removal from the 'grey list' to deploy an effective risk-based approach. The IA function should also keep abreast of future developments with respect to Schedule 3ZA and be prepared to further refine their testing approaches accordingly.





ECONOMIC CRIME UPDATE

BDO and NCA hold Suspicious Activity Reporting ('SAR') panel event

On the 29 June, BDO in conjunction with the NCA held a SAR panel event in light of the ongoing roll out of the new NCA SAR Portal.

The key take aways include:

- ▶ Understand the baseline behaviour of your customers so you can more accurately identify instances which are truly unusual or suspicious;
- ▶ Remain curious and inquisitive - if it does not feel right, it probably isn't;
- ▶ Have the confidence to articulate why your suspicion is 'more than fanciful';
- ▶ Set out the specifics in your SAR (the 'who, when, why where, how and who') which tell the story about the series of events which have led to your suspicion being raised; and
- ▶ Do not underestimate the importance of the information you hold and the SARs you raise - your SAR could be the missing puzzle piece and, when collated with other insights held by the NCA, could make a big impact.

BDO maintains a [SAR hub page](#) which is intended to act as a 'one-stop-shop' for SAR support.

The NCA also maintains [guidance](#) relating to SARs.



FOR MORE INFORMATION:

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