INTERNAL AUDIT SUPPORT

INVESTMENT & WEALTH MANAGEMENT UPDATE

August 2022

IDEAS | PEOPLE | TRUST

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.

LEIGH TREACY
PARTNER

+44 (0) 7890 562 098
leigh.treacy@bdo.co.uk

RICHARD WEIGHELL
PARTNER

+44 (0) 7773 392 799
richard.weighell@bdo.co.uk

CHRIS BELLAIRS
PARTNER

+44 (0) 7966 626 128
christian.bellairs@bdo.co.uk

BRUK WOLDEGABREIL
ASSOCIATE DIRECTOR

+44 (0) 7467 626 468
bruk.woldegabreil@bdo.co.uk

CONTENTS

Click on a section below to take you straight there

1 Effective internal audit planning

2 FCA's Consumer Duty - final rules and guidance

3 IFPR - The new prudential framework for investment firms

4 Financial Services and Markets Bill

5 FCA Market Watch 69 - MAR Surveillance

6 Economic Crime Update

7 Round-up from the Regulators

IA PLANNING FOR 2022/23: WHAT ARE THE SECTOR'S HOT TOPICS?

KARUNA BHANDERI
ASSOCIATE DIRECTOR

+44 (0) 7583 676 111
karuna.bhanderi@bdo.co.uk

BHAVIN BHARAKDA
ASSOCIATE DIRECTOR

+44 (0) 7970 969 012
bhavin.bharakda@bdo.co.uk

The August / September period is typically audit planning season and each year seems to have even more issues and developments for consideration than the previous year.

Key to risk-based auditing is prioritising the high risk areas for the IA team's activities over the coming year and assessing, with the help of an assurance map, where other assurance providers in the firm can be relied upon, and coordinated, to appropriately provide oversight and assurance to the Board to maximise the firm's resources.

Below is a thematic capture of the hot topics that IA teams within the sector should include as part of wider considerations for the audit plan. Almost all of the issues have been examined in this pack and its previous monthly editions (please do get in touch if you need prior articles); but lets first discuss best practice for the planning process.

► What does effective audit planning look like?

- **Risk Assessment**: fundamental to the planning process is a documented risk assessment of the firm-wide risks that could impact the firm's strategic objectives, with an articulation of the risks' impact and likelihood, to help prioritise risks. A risk heat map is ideal to visually capture the risk assessment for Board consumption and provide rationale for resource allocation on specific aspects of the audit universe (do remember, its impossible, and inefficient, to attempt to audit everything).
- **Think annual, update quarterly**: the concept on a once-and-done annual plan is fast becoming obsolete. To keep nimble to the firm's strategic objectives, which have to adapt to the continually evolving business, risk and regulatory landscape, its advisable to have an annual risk assessment inform an annual plan (the "trajectory") and updates incorporated on a rolling quarterly basis (the "tweaks"), or sooner for high risk / material issues, to ensure internal audit continuously adds value throughout the cycle.
- **Mapping the firm's assurance framework:** Internal Audit will likely be one of many other internal and external assurance providers for the firm's control framework, therefore owning the firm's assurance map and keeping it up to date can help plan the IA activities to complement (not duplicate) the assurance work of other specialists. Enhancing this aspect of the process to consider a 3-year horizon of the firm's assurance needs will also, if applicable, support the firm's transition into the anticipated BEIS-led audit reform requirement for an Audit and Assurance Policy.
- **Bring the business in**: audit planning must incorporate the expectations of senior management, therefore its important to schedule discussions early on with the business unit heads and examine their perspectives as risk owners. Facilitation of a control self assessment by the IA team, ahead of the planning process, could help unearth a wider set of issues and risks not yet captured by risk oversight teams. Maximising feedback from employee engagement surveys could also help identify risks closer to the frontline.
- **CIIA FS Code**: use of the CIIA's Financial Services Code of Practice (2021) should be considered as a benchmark of good practice and factored into the planning process. The Code should be applied proportionately, and therefore smaller firms should apply the principles on which the Code is based in light of the firm's size, risk profile and complexity of operations.
- **Benchmarking**: how does your planning process compare to industry peer teams? Discussion of current and best practices, within the sphere of industry and trade body forums, can help introduce improvements. This is especially the case for open-ended aspects of your planning process, e.g., how much of all engagement planning and fieldwork should aim to use computer-assisted auditing techniques?

IFPR Risk Mapping, Implementation and Financial Adequacy

Sustainability and ESG

Outsourcing & Third Party Risk Management

Operational Resilience

Cyber & IT security

Conduct risk, including Consumer Duty

Diversity & Inclusion

Economic Crime, including sanctions risk

Product Governance

Client Suitability

Change Management

FCA'S CONSUMER DUTY: FINAL RULES AND GUIDANCE

ALISON BARKER
SPECIAL ADVISER

alison.barker@bdo.co.uk

The FCA has published the final rules and guidance for the new Consumer Duty.

The Consumer Duty aims to improve the outcomes for retail consumers, including SMEs, setting clearer and higher expectations for firms' standards of care towards consumers by acting in good faith, avoiding foreseeable harm, and supporting customers in reaching their goals.

It goes much further than previous initiatives under Treating Customers Fairly.

► A new principle and new rules and guidance

The structure is unchanged from earlier consultations with a new Principle, three cross cutting rules and rules relating to four outcomes. Final Guidance provides examples and further detail.

The wording of the new Principle 12 will be "a firm must act to deliver good outcomes for retail customers". Existing Principles 6 and 7 will be disapplied where the Consumer Duty Principle applies but will be retained to apply to activities outside the Consumer Duty.

The cross-cutting rules provide more clarity on interpreting the new Principle and Rules and require firms to:

1. act in good faith toward retail customers
2. avoid foreseeable harm to retail customers
3. enable and support retail customers to pursue their financial objectives

► Four outcomes

The four outcomes represent key elements of the firm-consumer relationship to help ensure a comprehensive approach to achieving good consumer outcomes. Firms will need to understand and evidence how outcomes against each of these are being met. The four outcomes are:

- **Communications** – getting communications to consumers at the right time to equip customers to make effective, timely and properly informed decisions about financial products and services.
- **Products and Services** – to be designed to meet the needs of consumers; are sold to those whose needs they meet; and perform as expected.
- **Customer service** – that meets the needs of consumers, enabling them to realise the benefits of products and services and act in their interests without undue hindrance.
- **Price and Value** – to ensure that the price of products and services represent fair value for consumers.

► Deadlines for implementation

- New rules will be implemented on 31 July 2023 for all products and services currently on sale.
- Rules will be extended to closed book products (those that are no longer on sale) for implementation by 31 July 2024.
- FCA has required Boards to sign off on implementation plans by the end of October 2022 and maintain ongoing oversight of delivery.
- Manufacturers are required to share information with distributors by 30 April 2023 so that distributors can complete their implementation in time for the July deadline.

► Closed books

The FCA intends firms to bring closed book products up to the same standards as those currently available. This means closed books will be subject to all the Consumer Duty Rules on a forward-looking basis, i.e., the Consumer duty Rules will not apply retrospectively to past actions – the rules in place, at the time, will continue to apply.

The FCA has provided clarity on the application of the price and value outcomes for closed book products and expects firms to act where products do not meet the fair value standards.

There is no requirement on firms to amend vested contractual terms but consider alternative ways of achieving fair value such as amending (non-vested contractual) fees and charges and there is new additional guidance on this potentially challenging area.

► What should Internal Audit teams be thinking about?

- Internal Audit functions should have Consumer Duty impact assessment and implementation plans in scope to provide assurance to the Board that the firm is able to meet the implementation timescales.
- FCA supervisors will seek evidence of Board scrutiny. Boards are still required to attest that they meet the standards at the end of the implementation period. Therefore, IA teams should evaluate evidential sources of information of the Board's scrutiny over implementation plans, i.e. Board and committee discussion minutes, impact assessments produced by second line oversight functions, risks flagged by frontline teams – have these been incorporated into the firm-wide risk assessment?
- Facilitating a Risk and Control Self Assessment, including all the functional areas to be impacted by the new Consumer Duty, could help unearth a number of issues to better inform the preliminary risk assessment for a review of Consumer Duty implementation.

IFPR - THE NEW PRUDENTIAL FRAMEWORK FOR INVESTMENT FIRMS

GIOVANNI GIRO
ASSOCIATE DIRECTOR

+44 (0) 7392 125 492
giovanni.giro@bdo.co.uk

► What is the IFPR?

- The FCA's Investment Firms Prudential Regime (IFPR) is the new prudential framework that became effective on 1 January 2022, bringing all UK investment firms authorised under MiFID within the scope of a common regime. This regulatory reform marks a separation from the Capital Requirement Regulation (CRR), that remains applicable to banks and large investment banks, and aims at creating a dedicated prudential environment that is more proportionate to the business models and regulated activities of investment firms.
- Those groups that have a presence in the EU will have seen the implementation of the equivalent prudential regime for MiFID firms under the Investment Firm Regulation (IFR), which became effective in all Member States in June 2021.
- Firms in scope of IFPR include all FCA-authorised firms that hold MiFID permissions such as principal traders, financial advisers, stockbrokers, commodity derivatives dealers, MTF/OTF, wealth managers and also fund managers with a MiFID top-up. So all firms that used to be categorised as IFPRU investment firms or BIPRU firms are in scope, but also Collective Portfolio Management Investment firms (CPMI), exempt-CAD firms as well as some that were subject to the IPRU(INV) rulebook.
- The new rules sit in the MIFIDPRU sourcebook of the FCA Handbook and prescribe all key obligations around firm categorisation, prudential consolidation, own funds and liquid asset requirements, governance and risk management, internal capital adequacy and risk assessment (ICARA), public disclosure and regulatory reporting.

► What's new in the IFPR?

- The IFPR follows capital and liquidity adequacy standards that are broadly similar to the previous regime, but also introduces new concepts and methodologies that bring greater proportionality to prudential obligations.
- One major novelty is the split of firms in scope in two categories, the simpler ones as Small Non-Interconnected (SNI) vs the larger more complex firms (non-SNI).
- The own funds requirement for non-SNI firms includes a component based on 'k-factors', a set of coefficients applied to the size/volume of business carried out and which allows a firm to cover the 'risk of harm' posed.
- Liquidity becomes more prominent in the IFPR, as firms must maintain a minimum amount of liquid assets and determine a liquid asset threshold requirement.
- Wind-down planning becomes fully mandatory and firms must calculate the cost of an orderly wind-down to determine the own funds and liquid assets to be held.

► Key aspects of the IFPR:

- Firm categorisation – SNI and non-SNI
- Three levels of Permanent Minimum Requirement (PMR)
- Fixed overhead requirement for all firms
- New 'k-factor' requirement
- Risk assessment focus on harm to clients, the market and the firm
- Mandatory Basic Liquid Asset Requirement (BLAR)
- Overall Financial Adequacy Rule (OFAR)
- 'Own funds threshold requirement' (OFTR) and 'Liquid assets threshold' requirement (LATR)
- Early warning, threshold breach and wind-down triggers
- Prudential consolidation includes 'connected undertakings'
- ICARA – Internal capital Adequacy and Risk Assessment
- Wind-down planning
- Quarterly regulatory reporting (MIF data items)
- Governance and risk management standards
- Remuneration Code – 3 levels
- Public disclosures

► **Permanent Minimum Requirement**: £75,000, £150,000 and £750,000 depending on a firm's permissions

► **Fixed Overhead Requirement (FOR)**: calculated as ¼ of the fixed overheads of the preceding year, after deduction of variable expenses

► **K-Factor Requirement**: is the sum of all k-factor requirements that apply to a firm based on its permissions:

- K-AUM - Assets Under discretionary/advisory Management
- K-ASA – Client Assets Safeguarded and Administered
- K-CMH - Client Money Held
- K-COH - Client Orders Handled
- K-NPR - Net Position Risk; or
- K-CMG - Clearing Margin Given
- K-TCD - Exposure to Trading Counterparties Default
- K-CON - Concentration risk based on large exposures
- K-DTF - Operational risks from Daily Trading Flow

► **Basic Liquid Asset Requirement**: is the minimum amount of liquid assets a firm must hold at all times calculated as 1/3 of the FOR

IFPR – THE NEW PRUDENTIAL FRAMEWORK FOR INVESTMENT FIRMS

▶ ICARA – the new ICAAP

- The internal capital adequacy and risk assessment is a process that all SNI and non-SNI firms must implement to demonstrate their ability to meet the OFAR and determine the amount of own funds and liquid assets they must hold in order to:
  - maintain a sustainable business through their economic cycle; and
  - complete an orderly wind-down.
- The ICARA is the most important and comprehensive document that a firm must hold and broadly inherits some key concepts from the ICAAP. It does, however, add a number of important aspects, including, for instance, the liquid asset threshold requirement and the importance of wind-down costs in assessing the mandatory amount of financial resources needed.
- The risk assessment process must now be based on the risk of harm that a firm poses to its clients, the market and to itself. Risk exposures are covered by k-factors to some extent, but a firm must assess the actual financial impact of harms in order to determine how much capital and cash it should hold.
- The OFAR is a requirement that became effective on 1 January 2022. Therefore, firms in scope were expected to develop the ‘ICARA processes’ sufficient to calculate its OFTR and LATR having completed a risk assessment, stress test and scenario analysis, recovery planning and wind-down planning to confirm whether any additional capital or liquid assets must be held over and above PMR, FOR, KFR.
- The FCA expects all ICARA processes to be embedded in an ‘ICARA document’, confirming that all constituent parts are in place and the whole process is adequate. This includes the ‘point in time’ assessment, but also forward-looking projections for business model planning, financial forecasting and stress testing.
- ICARAs are visible to the FCA via the information submitted in the MIF007 return annually, but also through the Supervisory Review and Evaluation process (SREP).

▶ Wind-down planning

- Wind-down plans are extremely important in the new prudential framework, and must be comprehensive, credible and operable. The calculation of wind-down costs is essential to the OFAR and affects both the own funds and the liquidity requirements applicable.
- In a recent thematic review, the FCA confirmed that wind-down planning must be designed according to their guidance and standards, be risk-based, focus on cashflow management and consider group-wide implications.

▶ Implementation challenges

- Over the past months, when firms were preparing for the implementation, as well immediately after the effective date, we helped many clients throughout the transition to the new framework and also observed a few difficulties that firms in scope encountered in the process of complying with the new requirements.
- In most cases it has been a matter of interpretation and practical application of the rules, but in some instances the challenge is posed by the great effort required in adapting pre-existing structures and arrangements to new, more demanding, processes, increased financial resources required and the completely new components of a firm’s prudential infrastructure.
- **Key areas of challenge include:**
  - Interpreting the new rules on prudential consolidation correctly;
  - Understanding the process and methodology for the K-factor calculations;
  - Applying IFPR transitional provisions where possible despite a prevailing requirement dictated by the OFAR;
  - Calculating the OFTR and LATR on the basis of a partial ICARA process;
  - Reporting all financial data correctly even where firms may not have documented the rationale and conclusions of their regulatory returns;
  - Adapting internal processes and policies to the new requirements in a comprehensive and consistent update of a firm’s prudential infrastructure.

▶ What should Internal Audit teams be thinking about?

- Consider reviewing the design and effectiveness of the controls and processes implemented by firms in scope in their IFPR journey.
- Assess and challenge the appropriateness of the methodology adopted in the calculation of own funds and liquid asset requirements.
- Review all documented ICARA processes to assess completeness and proportionality.
- Review the quality and accuracy of regulatory reporting.
- Perform IFPR consolidation analysis in groups of firms that may be subject to prudential consolidation.
- Establish regular reviews of those annual processes (e.g., ICARA, remuneration, public disclosure) that must be maintained and updated.

FINANCIAL SERVICES AND MARKETS BILL

ALISON BARKER
SPECIAL ADVISER

alison.barker@bdo.co.uk

The new Financial Services and Markets (FSM) bill was laid before Parliament on 20 July 2022. Debates on the new proposals will not start until September. Its most significant purpose is to enable a comprehensive UK based financial services regulatory regime post Brexit and sets the framework to repeal and replace EU regulations (retained EU law).

Strategically it is aimed at maintaining and growing the UK as a global financial services centre, fostering innovation and supporting the agenda for levelling up in the UK.

It will take some years for regulators to work through the body of retained EU law. In the majority of cases, normal policy making processes will be followed with proposals for change put forward in consultation with the normal cost benefit analysis.

New objectives for the FCA and PRA

- In a drive to make UK financial services more attractive long term, both the FCA and PRA will have growth and international competitiveness as objectives, as well as 'have regard to' climate change and net zero targets when discharging regulatory functions. Competitiveness is not to be prioritised above financial stability or consumer protection.
- There are changes that make regulators have greater accountability to Parliament, strengthen the function of statutory Panels, including placing the Listing Panel on a statutory basis, and to create Cost Benefit Advice panels. HMT will have power to direct regulators.

Main areas of change

- **A new Designated Activities Regime -** which will allow activities not compatible with the scope of FSMA legislation to be included. An example would be short selling. Powers are provided to FCA to set out how the activity should be carried out and to enforce.
- **MiFID** - Nine changes to the MiFID II framework: (1) Removing the Share Trading Obligation; (2) Replacing the pre-trade transparency waiver regime and removing the Double Volume Cap; (3) Changing the definition of a systematic internaliser; (4) Removing restrictions on midpoint crossing for trades; (5) Aligning the Derivatives Trading Obligation with the EMIR Clearing Obligation; (6) Exempting for post-trade risk reduction services from the DTO; (7) Giving the FCA a permanent power to modify or suspend the DTO; (8) Simplifying the transparency regime for fixed income and derivatives; (9) Simplifying the position limits regime.
- **Powers of UK Regulators** - Another area of retained EU law change will be the powers for UK regulators (Bank of England and FCA) to oversee financial market infrastructure which had been a preserve of EU regulation. Provisions are also set out to apply the SMCR regime to FMIs and credit rating agencies.
- **Financial promotions** - the existing financial promotions regime is complex and has proved difficult for the FCA to regulate resulting in misleading promotions of complex financial products. Proposals for tightening the regime will mean that those firms wishing to approve promotions of unauthorised firms will require permission from FCA. Firms will be restricted to approvals within their sphere of expertise.
- **Crypto payments and changes to the EMI and payment services regulations** - a framework for regulating crypto in the UK is lagging behind other jurisdictions. The bill brings activities facilitating the use of certain stable coins used for payment within the regulatory perimeter. Further Government consultation on crypto assets used as investments is expected later in 2022.
- **Critical Third Parties** – the legislative framework for the new CTP regime is set out giving HMT powers to designate critical third parties. A Discussion Paper was jointly released by regulators providing thoughts on the new regulatory framework.

What should Internal Audit teams be thinking about?

- This is a substantial and wide ranging piece of legislation which will be the start of more detailed changes from regulators. For firms, this will mean changes to be implemented over a number of years and, therefore, requires a long-range programme of regulatory development to maintain the firm's compliance with post-Brexit requirements.
- Heads of Internal Audit need to keep close to Board and Audit Committee discussions regarding strategic changes required to meet incoming regulatory expectations. Discussion now with the firm's legal counsel for its analysis of legislative changes, especially considering cross-border regulated activities, will prove useful in identifying the key risks facing the firm as each wave of supervisory and policy statements are published in due course.
- Second line oversight functions should be preparing for a period of change and maintaining an ongoing impact assessment to monitor proposals and impact of changes. Therefore, Heads of Internal Audit will need to evaluate the current and anticipated resource requirements for the IA activity to provide sufficient oversight of incoming regulatory developments.
- Given the substantial amount of regulatory developments expected over the coming years, this could prompt reassessment of the firm's assurance map. Coordinating the firm's various assurance providers for efficient and effective risk management over the three-year horizon would maximise efforts and, if a public interest entity (PIE), play well into the incoming requirement for an Audit and Assurance Policy as part of the anticipated Audit Reform bill requirements.

FCA MARKET WATCH 69: FCA OBSERVATIONS ON FIRMS' MARKET ABUSE SURVEILLANCE

ED NEWMAN
DIRECTOR

+44 (0) 7958 354 444
ed.newman@bdo.co.uk

BRUK WOLDEGABREIL
ASSOCIATE DIRECTOR

+44 (0) 7467 626 468
bruk.woldegabreil@bdo.co.uk

▶ FCA Market Watch 69

- In May 2022, the FCA published its latest Market Watch newsletter in which it summarised its observations from its supervisory engagements with small and medium-sized firms.
- The three main areas of focus for Market Watch 69 were:
  - Market abuse surveillance;
  - Policies and procedures to address criminal market abuse;
  - Investigations into potential market abuse by firms' employees and when firms should submit a suspicious transaction and order report (STOR).

▶ What were the FCA's observations?

- **Front office**: FCA observed some firms that place a reliance on front office staff to identify potential market abuse, sometimes giving them sole responsibility for monitoring. In other instances, firms cited front office's role as mitigation for a limited or absence of surveillance in Compliance.
- **Outsourcing**: In a small number of cases, FCA found that UK Compliance teams had negligible understanding of the surveillance undertaken at group level (for overseas firms), and following FCA investigation, the regulator discovered the surveillance put in place by Group was ineffective for the UK business.
- **Policies & procedures**: FCA observed instances where policies and procedures are vague or have limited detail, such as directing analysts reviewing surveillance alerts to look for signs of market abuse, but with no guidance on what these signs might be, or what materials / information to use or consider.
- **Order & Trade surveillance:**
  - If a firm uses a common threshold in its alert scenarios for all instruments, it may struggle to ensure effective monitoring (the threshold is set too high/too low for some instruments), or it may generate a high amount of 'noise' (the alert is calibrated to the most sensitive of the instruments);
  - FCA observed instances where firms are not monitoring all orders and trades, including cancelled and amended orders;
  - FCA have seen some firms with weaknesses in their review of surveillance exception alerts.
- **MAR Risk Assessments:**
  - Some firms consider market abuse at a high level, as a single risk;
  - Some look at the risk by desk without assessing different types of market abuse;
  - Some assess only insider dealing and market manipulation, without considering how different levels of risk might apply to different sub-categories of these, such as layering and spoofing, wash trading and ramping;
  - Some firms whose business involves activity across a range of asset classes fail to distinguish between them when assessing for risk;
  - Some do not consider how different types of business activity, such as discretionary vs execution-only, or client vs house trading, might present different market abuse risks;
  - Some firms do not consider the method of execution (e.g., electronic vs voice-broked markets) or the nature of the platform where the trading takes place (e.g. lit vs dark books, central limit order book vs auction);
  - Some firms completely discount the risks in certain business areas because of low trading volumes, without considering the inherent risks.

▶ What should Internal Audit teams be thinking about?

- **Policies and procedures:** are these clear and up to date with FCA's Market Watch findings? Do they factor in relevant guidance for business with overseas entities (e.g. FINRA for US counterparties)? What system of staff training is in place to ensure policies and procedures are understood, followed and its compliance monitored such that any deviations to controls are flagged as soon as possible? Are MAR controls embedded within the firm's Conduct Risk framework?
- **Risk Assessments:** its impossible to assess a risk for an undefined activity or behaviour. Given the wide variety and complexity of MAR compliant activities a firm can undertake, its critical that the business has appropriately categorised its universe of FCA-permitted activities and that Compliance has defined Market Abuse behaviours in relation to these activities. Only then can a robust risk assessment take place ahead of IA facilitating an objective review of MAR controls, putting priority on high risk areas, e.g. order and trade surveillance.
- **Outsourcing**: an opportunity to, where applicable, co-ordinate a review of outsourced MAR surveillance as part of the firm's third-party Outsourcing review.

ECONOMIC CRIME UPDATE

WILL WOODWARD
MANAGER

+44 (0) 7823 898 674
william.woodward@bdo.co.uk

NCA Red Alert on Financial Sanctions Evasion Typologies: Russian Elites and Enablers

- In July 2022, the National Economic Crime Centre (NECC), a multi-agency unit in the National Crime Agency (NCA), and HM Treasury's Office of Financial Sanctions Implementation (OFSI), working in conjunction with law enforcement and financial sector partners as part of the Joint Money Laundering Intelligence Taskforce (JMLIT), issued a 'Red Alert.'
- The purpose of the 'Red Alert' is to provide information from law enforcement and the legal and financial services sectors about common techniques designated persons (DPs), individuals and entities subject to financial sanctions, and their UK enablers are suspected to be using to evade financial sanctions.

What does the 'Red Alert' say?

- The 'Red Alert' explains how some DPs are using a range of techniques in order to evade sanctions impacting on their personal and commercial holdings. This activity is occurring shortly before the imposition of sanctions or soon after. DPs are transferring or selling assets, sometimes at a loss, and divesting investments to reduce ownership below 50% or relinquish controlling stakes.
- A DP may claim to have relinquished the asset, but the 'Red Alert' states that it is highly likely that they will retain their influence through trusted proxies and enablers. Enablers are individuals or businesses facilitating sanctions evasion and associated money laundering. Key enabler professions include:
  - Legal (barristers and solicitors)
  - Financial (relationship managers, accountants, investment advisors, wealth managers, payment processors, private equity, trust and company service providers)
  - Estate agents
  - Auction houses
  - Company directors, Intermediaries/agents and private family offices
- The 'Red Alert' lists 34 indicators for the detection of frozen asset transfers, detection of enablers and the detection of suspicious payments.
- Many of these cover existing risks like the abuse of trust structures, holding companies located offshore or in jurisdictions historically linked to the Soviet Union, and transactions by holding companies linked to DPs with Swiss bank accounts and BVI/Cypriot legal persons.
- The 'Red Alert' also mentions payments from offshore jurisdictions, the Middle East, East Asia or jurisdictions that still support the Russian government or express neutrality in international forums like the UN.
- In terms of what appear to be emerging trends, the 'Red Alert' notes the risk of payments via a Fintech (e.g. a payment service provider or electronic money institution) with Russian investor nexus.
- This could include customer transactions that are initiated from or sent to IP addresses that have non-trusted sources, or are located in Russia, Belarus, jurisdictions with FATF-identified Anti-Money Laundering (AML) deficiencies or comprehensively sanctioned jurisdictions.

What should Internal Audit teams be thinking about?

The 'Red Alert' specifies six recommendations:

1. Arms-length transactions need to be documented and should not be taken at face value by firms. If they have any doubt, firms are advised to seek guidance from OFSI.
2. Paying particular attention to source of wealth and source of funds checks, especially if conducted by third parties.
3. Making a careful assessment of complex corporate structures as a key component of enhanced due diligence on high-risk customers.
4. Issues of aggregation of ownership can be further complicated where differing approaches to aggregation of ownership are applied across the EU, UK and US and more than one owner seeks to divest their shareholding. Firms are advised to seek guidance from OFSI if in doubt.
5. Where firms are presented with documentation that purports to present a change in ownership by a company linked to a DP, it is important not only to conduct enhanced due diligence, but to follow up with the relevant competent authority (OFSI in the UK) to understand if firms have reason to believe that ownership has not been transferred appropriately.
6. When companies have provided their own legal assessments regarding the transfer of ownership, firms should also carry out their own legal assessment in order to come to their own determination.

- The 'Red Alert' also reminds us that, as a tool of foreign policy, UK sanctions have jurisdiction both over England, Wales, Scotland and Northern Ireland, as well as the Crown Dependencies and Overseas Territories (which includes BVI).

ECONOMIC CRIME UPDATE

The 'Red Alert' focuses on the evasion of sanctions by DPs and the movement of funds or ownership shortly before, or immediately after, the imposition of sanctions.

Notwithstanding the recommendations made within the 'Red Alert', IA teams should also consider the following:

- Firms should re-visit their Business-Wide Sanctions Risk Assessments to ensure that they adequately consider the inherent risk of their businesses being exposed to attempted sanctions evasion by DPs or their UK enablers.
- Now is a good time for firms to examine the calibration and functioning of the firm's screening systems. This could also involve an assessment of how there have been changes to alert numbers and the quality of potential matches. Considering the current sanctions climate it is imperative that firms pay even closer attention to sanctions risks and the many complex ways that they present themselves.
- With sanctions lists being frequently changed and updated in the current circumstances, firms should also confirm that the third party providers supplying watchlist data are continuing to ensure that every amendment to the various lists of sanctioned entities is captured.
- Any firms which become aware of any information (as part of their business relationships) which is indicative of the typologies listed in the 'Red Alert' should consider submitting a Suspicious Activity Report (SAR) to the NCA.
- Further, (as noted in the alert) firms should also consider contacting the NCA with any other relevant information identified in light of the 'Red Alert'.

► FATF Report on Data Protection, Technology and Private Sector Information Sharing

- The Financial Action Task Force (FATF) released a report on 20 July 2022, which focuses on how responsible private-to-private collaboration can contribute to the effective implementation of AML/CFT and proliferation financing requirements.
- The report provides case studies that set out how members of the FATF and its Global Network have increased private sector information sharing within the legal requirements of their domestic data protection and privacy (DPP) framework.
- The report also provides non-binding recommendations to assist countries that are considering increasing private sector information sharing to design and implement such initiatives responsibly and effectively.

► What should Internal Audit teams be thinking about?

The FATF report makes a series or recommendations :

- **Make use of privacy enhancing technologies**: privacy-enhancing technologies can help support compliance with data protection and privacy obligations. When considering the application of these technologies firms should think about the interoperability and accessibility of different technologies to promote broader engagement.
- **Ensure harmonised data**: data-sharing technologies, especially advanced analytics, work best with common data standards and formats. Firms could make use of existing data prepared in a structured format (e.g. SWIFT data fields) or implement data cleansing/structuring initiatives.
- **Pursue Data Protection 'by design'**: during the design phase of any initiative, firms should consider producing a data protection impact assessment, data sharing agreements/contracts, human rights impact assessments and a legitimate interest assessment to help data controllers evaluate the necessity and proportionality of anticipated data processing.
- **Establish early and ongoing engagement with data protection authorities**: Involvement of data protection authorities is critical for the success of any information-sharing project. Likewise, engagement with AML/CTF regulatory authorities can also be vital to a project's chances of success.
- **Identify metrics to measure success**: Setting clear performance indicators enables participants to assess whether the initiative is achieving its purpose and if the information sharing continues to be necessary, reasonable or proportionate in line with applicable DPP requirements. Sharing positive outcomes and results also helps build trust and encourage broader involvement. It is worth noting the former NCA deputy director's comments where he suggested that people should "dare to share." This quote related to his reflections about the challenges faced by both public and private sector stakeholders when establishing the now successful Joint Money Laundering Intelligence Taskforce (JMLIT).

A ROUNDUP FROM THE REGULATORS

REGULATOR	DATE	DOCUMENT	WHAT'S NEW?
FCA	29/06/2022	FS22/4	Feedback statement which sets out the FCA's policy response for ESG integration in UK capital markets
FCA	04/07/2022	DP21/4	Discussion on new sustainability disclosure requirements and a new classification and labelling system for sustainable investment products
FCA	05/07/2022	CP22/12	Improving equity secondary markets: consultation for rule changes to improve trade execution and post-trade transparency for investors
FCA	06/07/2022	PS22/8	Final rules and guidance which allow authorised fund managers to create separate unit classes (side pockets) for retail investment funds affected by the invasion of Ukraine
PRA	12/07/2022	CP11/22	Margin requirements for non-centrally cleared derivatives: Amendments to Binding Technical Standards 2016/2251
PRA	15/07/2022	CP8/22	Remuneration: proposed changes to unvested pay, Material Risk Takers and public appointments
PRA	19/07/2022	Index	A new Prudential and Resolution Policy Index, which provides a list of policies relating to the prudential regulation
PRA	22/07/2022	CP13/22	Amendments to the PRA's approach to identifying other systemically important institutions (O-SIIs)
FCA	01/08/2022	CP22/14	Broadening retail access to the long-term asset fund (LTAF): draft rules to market the LTAF to a wider group of retail investors and pension schemes
FCA	01/08/2022	PS22/10	FCA's final policy and handbook rules for high-risk investments subject to financial promotion rules and for firms communicating and approving financial promotions

FOR MORE INFORMATION:

RICHARD WEIGHELL

+44 (0) 7773 392799
richard.weighell@bdo.co.uk

This publication has been carefully prepared, but it has been written in general terms and should be seen as containing broad statements only. This publication should not be used or relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained in this publication without obtaining specific professional advice. Please contact BDO LLP to discuss these matters in the context of your particular circumstances. BDO LLP, its partners, employees and agents do not accept or assume any responsibility or duty of care in respect of any use of or reliance on this publication, and will deny any liability for any loss arising from any action taken or not taken or decision made by anyone in reliance on this publication or any part of it. Any use of this publication or reliance on it for any purpose or in any context is therefore at your own risk, without any right of recourse against BDO LLP or any of its partners, employees or agents.

BDO LLP, a UK limited liability partnership registered in England and Wales under number OC305127, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. A list of members' names is open to inspection at our registered office, 55 Baker Street, London W1U 7EU. BDO LLP is authorised and regulated by the Financial Conduct Authority to conduct investment business.

BDO is the brand name of the BDO network and for each of the BDO member firms.

BDO Northern Ireland, a partnership formed in and under the laws of Northern Ireland, is licensed to operate within the international BDO network of independent member firms.

Copyright © August 2022 BDO LLP. All rights reserved. Published in the UK.

www.bdo.co.uk