PORTMAN COMPLIANCE

This Quarter's Regulatory Round-up

July 2022

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United Kingdom

Consultation on proposals aimed at improving UK equity market

The FCA has published a Consultation Paper (CP22/12) on proposals aimed at improving the functioning of equity secondary markets.

The changes are part of the Wholesale Markets Review (WMR), which the FCA has been conducting alongside the Treasury to improve the UK's regulation of secondary markets. The Treasury's consultation response to the WMR advised that the FCA would reform the parts of the regime that are set out in regulatory rules and guidance to ensure that the most burdensome and unnecessary regulatory requirements are removed as soon as possible.

The CP proposes to lower the cost of reporting for firms, improve post-trade transparency and remove some restrictions that are limiting the ability of UK trading venues to compete with other markets.

In particular, the FCA believe the changes it is consulting on would:

- Improve the content and consistency of post-trade transparency reports.
- Establish a new designated reporter status for OTC trades.
- Allow UK trading venues to use reference prices from overseas markets where those prices are robust, reliable and transparent.
- Permit the use of the tick size regime from overseas primary markets.

Interested parties have until 16 September 2022 to provide comment for consideration by the Regulator.

Regulatory changes in the crypto space

HM Treasury published its response to the consultation on amending the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("the MLRs") in June 2022.

The consultation implements provisions that ensure compliance with the Financial Action Task Force's ("FATFs") crypto Travel Rule by amending UK law.

The Travel Rule requires countries to ensure that financial institutions send and record information on the originator and beneficiary of wire transfers, and that information remains with wire transfers throughout the payment chain. Crypto firms will be required to adhere to this standard; subject to a de minims threshold and an exemption for transfers between UK based crypto asset firms. The consultation confirms that it is not intended that the additional information will be sent "on chain" but through a separate private system, thus alleviating privacy concerns.

The changes will come into effect, if approved by Parliament, in September 2023 to allow firms the time needed to achieve compliance.

Changes to FRNs and PRNs

The FCA currently utilises six-digit reference numbers to uniquely identify firms (i.e. Firm Reference Number (“FRN”)) and funds (i.e. Product Reference Number (“PRN”)).

The Regulator has recently announced that, due to the volume of applications and notifications it receives, it expects to reach the six-digit limit sometime in 2023.

As a result, the FCA is planning to move to seven-digit FRNs and PRNs at an as-yet undecided date sometime in 2023.

The new seven-digit unique numbers will only apply to newly registered firms and funds; those that have previously been allocated a six-digit reference FRN or PRN will keep that number.

FCA speeding up removal of firms that do not use their regulatory permissions

Back in January 2021, the FCA announced its ‘use it or lose it’ initiative. Specifically, that firms should review their regulatory permissions on an ongoing basis to ensure they are up to date and removed where they are not needed. The FCA noted that it has the power to cancel or amend a firm’s Part 4A permission if it has not carried on a regulated activity for at least 12 months.

To supplement this, in May 2022, the FCA announced that it is to use new powers to more swiftly cancel or amend a firm’s scope of permission.

Under the new arrangement, where the FCA believes that a firm is not using a regulatory permission, it will issue the firm with two warnings. The Regulator will then be able to cancel, or amend, the permission 28 days after the first warning if the firm has not taken appropriate action.

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Feedback to discussion on ESG topics

In June 2021 the FCA issued consultation paper CP21/18 on climate-related disclosure rules, the FCA included a discussion chapter on some ESG issues in capital markets, such as:

1. Issues related to green, social and sustainable debt instruments; and
2. ESG data and rating providers.

On June 29 the FCA published its feedback on the Consultation from industry participants. The FCA see a rationale for the regulation of ESG rating providers.

1. The FCA is encouraging issuers of ESG-labelled Use of Proceeds (UoP) debt instruments to consider voluntarily applying or adopting relevant industry standards, such as the Principles and Guidelines that the International Capital Market Association (ICMA) has developed for green, social, and sustainability bonds.
2. It also reminds issuers, their advisors and other relevant market participants, of their existing obligation to ensure any advertisement is not inaccurate or misleading and is consistent with the information contained in the prospectus.
3. Finally, the FCA encourages issuers and their advisors to consider verifiers' and assurance providers' expertise and professional standards, and to engage with second party opinion (SPO) providers and verifiers who adhere to appropriate standards of professional conduct, such as ICMA's Guidelines for External Reviewers.

There is no suggested timeline of next steps, we will monitor the situation closely.

EC issues general approach on AIFMD II

The EU Council has issued a General Approach on the European Commission's proposals to amend the AIFMD (AIFMD II).

The General Approach is essentially an updated version of the draft issued in November 2021. The detailed changes are predominantly concerned with the following:

1. Delegation
2. Loan origination
3. Liquidity risk management
4. Data reporting
5. Depositaries

There is still time for changes to be made before the text is finalised. The changes suggested could be around ESG measures as we discussed in our previous update. We will monitor these developments closely.

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UK Government plans for reform of UK data protection regime

In September 2021, the UK Government launched a consultation on proposals to reform the UK's data protection regime following the UK leaving the EU. Generally speaking, the proposals were to relax standards in favour of business growth and innovation. In June 2022, the UK Government published its response to the consultation. The result are proposals that diverge from the European General Data Protection Regulation ("EU GDPR") but, in contrast to the original proposals, would not amount to significant reform of the legislation. The response considers five areas as follows:

- Reducing barriers to responsible innovation: reducing restrictions on the use of personal data in connection with scientific research and introducing a pre-approved list of legitimate interests for businesses to process personal data without the need to apply a balancing test to determine if the rights and freedoms of data subjects override the interests of the business in processing data.

- Mitigating burdens on businesses and improving better outcomes for people:
    - reducing risk management requirements for business by introducing flexibility relating to obligations such as the need to appoint a Data Protection Officer, record keeping and Data Protection Impact Assessments;
    - requiring risk-based privacy management programmes to keep high standards in place; and
    - changing Cookie consent requirements from an "opt-in" to "opt-out" model.

- Minimising barriers to data flows:
    - permitting the UK Government to take a risk-based approach to adequacy assessments of third countries increasing flexibility; and
    - introducing new powers for the UK Government to recognise new alternative transfer mechanisms for countries not subject to an adequacy decision.

- Improving public services: supporting personal data sharing in the public sector to improve public services delivery.

- Reform of the Information Commissioner's Office ("ICO"):
    - modernising governance of the ICO by introducing a statutory board;
    - introducing new statutory objectives for the ICO to promote data subject rights as well as growth, innovation, and competition; and
    - enabling the ICO to take a proportionate risk-based approach to complaint handling.

It remains to be seen which of the UK Government's proposals will pass into law as any changes will have to go through the UK's usual legislative process.

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FCA Business Plan 2022/23

On 7 April 2022, the FCA published its business plan for 2022/2023 setting out the key work it intends to carry out over the next 12 months. The FCA groups its commitments for the year into three areas:

- Reducing and preventing serious harm: focussing on protecting consumers from the harm that authorised firms can cause, including tackling fraud and poor treatment.

- Setting and testing higher standards: focussing on the impact that authorised firms' actions have on consumers and markets. The FCA say they expect all firms they regulate to adopt the same high standards and have an open and cooperative approach.

- Promoting competition and positive change: using competition as a force for better consumer and market outcomes. The FCA say they intend to support UK growth and innovation that serves society, underpinned by widely recognised and respected high standards.

In order to deliver on its commitments, the regulator states it will achieve these in the following manner:

- Outcomes and measurement: reporting publicly on outcomes and metrics to measure progress against commitments.

- Transformation:
    - Becoming a data-led regulator that is more effective at using data, converting it into actionable intelligence, improving real time understanding of markets and risks;
    - Using streamlined decision making and governance processes, such as the move of some decision-making processes on statutory notices, from the Regulatory Decisions Committee to Executive Procedures;
    - Working towards internal diversity and inclusion targets; and
    - Strengthening the regulator's presence across the whole of the UK, for example, by opening an office in Leeds.

- Activities: setting out the year's activities to deliver on commitments through planned work.

The FCA has set out three focus areas for its activities as follows:

- Focus 1 – Reducing and preventing serious harm:
    - Dealing with problem firms: acting faster against firms that cause harm to consumers and/ or markets;
    - Improving redress: making sure consumers can get the redress they are owed;
    - Reducing harm from firm failure: minimising the fallout for consumers when firms fail;
    - Improving oversight of appointed representatives: increasing the information principal firms provide to the regulator and raising standards;
    - Reducing and preventing financial crime: reducing incidence of fraud and money laundering; and
    - Assertive action on market abuse: ensuring firms have strong preventative cultures, systems and controls, monitoring data and taking action.

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FCA Business Plan 2022/23 (*continued*)

- Focus 2 – Setting and testing higher standards:
    - Putting consumers' needs first: setting clearer and higher expectations for the standards of care and customer service firms give consumers;
    - Enabling consumers to help themselves: ensuring consumers have the information they need to make good decisions;
    - Environmental, Social and Governance ("ESG") priorities: embed ESG work across the FCA to support the financial sector in achieving positive change; and
    - Minimising impact of operational disruptions: enforcing rules and guidance to strengthen operational resilience and dealing with those unable to meet high standards.

- Focus 3 – Promoting competition and positive change:
    - Preparing for the future: tailoring regulations to suit UK firms following introduction of new powers proposed by the Treasury;
    - Strengthening wholesale markets: delivering a proportionate regime that upholds high standards and supports innovation; and
    - Shaping digital markets to achieve good outcomes: better understanding emerging risks and opportunities to establish a framework for good outcomes in digital markets.

FCA early oversight project

The FCA have introduced an initiative called Early and High Growth Oversight. The programme provides enhanced supervision for newly authorised firms helping them to understand and comply with their regulatory obligations and follows a successful pilot. The objectives of the programme are to: spot harm or misconduct and address it, raise standards from newly authorised firms, help innovative firms that may not have the same resources as traditional financial services firms and provide firms with a better experience via direct and immediate access to the regulator.

Reporting on the pilot, the FCA identified common themes as follows:

- Working with firms to understand marketing/ financial promotion requirements;
- Supporting firms with regulatory data submissions;
- Firms with incorrect permissions;
- Business plans at authorisation that may not accurately reflect business after launch;
- Firms changing their business models impacting the regulatory permissions they hold or need;
- Innovative firms without the same resources to understand regulatory requirements as traditional firms; and
- Firms generally rating the experience provided by the FCA through the pilot positively.

In 2022/2023, newly authorised firms that are part of the programme will be contacted by the FCA.

FCA observations on wind-down planning

On 11 April 2022, the FCA published its Thematic Review (TR22/1) detailing its findings following investigations into the wind-down planning practices of some of the largest regulated firms.

Under the Threshold Conditions, all regulated firms are expected to have adequate financial and non-financial resources. As part of this, the FCA expects firms to have a plan in place to enable an orderly wind-down should such circumstances arise, pointing to the economic stresses caused by the ongoing Covid-19 pandemic as an example.

The FCA's review noted the following key observations:

- Liquidity in wind-down: Firms are required to hold appropriate liquid assets to continue to pay its liabilities as they fall due, including in the case of a firm winding-down. The FCA suggested that the holding of 'ring-fenced' liquidity, explicitly for the purposes of wind-down, separate from other existing liquidity requirements, to be good business practice. The Regulator observed that issues arising during wind-down could be broadly categorised into three categories: (i) Cashflow timing mismatches; (ii) firms inaccurately calculating costs in wind-down and, therefore, not having an accurate awareness of the net cash impact of wind-down; and (iii) firms not considering the potential impact a wind-down scenario would have on its cash balance at the start of a wind-down.

- Approach to quantifying liquidity for orderly wind-down: Where firms had completed cashflow modelling exercises to determine an appropriate amount of liquid assets to be available at wind-down, the FCA noted that many of the models it viewed lacked granular detail or were very simplistic, in some cases using the Fixed Overhead Requirement as a proxy. As a result, the FCA views that firms may be over or under-estimating their liquid assets needs and suggest that more sophisticated approaches would yield more accurate results.

- Intragroup Dependencies: For firms within groups, the FCA noted that it saw inadequate consideration of group membership on firms' ability to wind-down. Specifically, while firms tend to consider the positives that being a member of a group bring, considerations to the stresses caused by interconnectivity, such as for example, parental failure and/or the lack of availability of significant shared intra-group functions (such as HR or IT), tended not to be considered.

- Wind-Down Triggers: The FCA noted that wind-down triggers are an essential part of wind-down planning and should be considered as an initiation point for firms to act and consider whether wind-down is required. However, many firms failed to consider an appropriate range of wind-down trigger metrics and, in many cases, the calibration of the wind-down triggers was not justified.

The FCA suggests that firms may find it helpful to consider its observations when carrying out their own wind-down planning and that firms may benefit from integrating their wind-down planning process with their Risk Management Framework, including own fund and liquid asset adequacy assessments.

Market Watch 69

In its May 2022 Market Watch, the FCA discussed its observations on the market abuse surveillance arrangements of small to medium sized firms in the industry.

The FCA highlighted how the implementation of a comprehensive, accurate and up-to-date market abuse risk assessment can assist firms in adequately identifying market abuse risks, thus allowing firms to implement tailored and effective monitoring programmes and surveillance arrangements. In the Regulator's opinion, the most effective assessments involve consideration of the different types of market abuse and how they apply across different areas of the business and asset classes.

While the FCA noted that it had seen increased use of automated order and trade surveillance systems, it noted that not all firms are using such systems effectively. Specifically, the FCA noted that it had seen examples where calibration of alert scenarios had been made which were not specific to the characteristics of different asset classes and instruments traded by firms, leading to false positives. Examples of a general lack of understanding of how third-party vendor alert scenarios work in practice were also noted by the Regulator. In addition, the FCA found examples of firms failing to monitor cancelled and amended orders, which it sees as critical in identifying certain forms of market manipulation, such as those that involve false or misleading signals to other market participants.

The FCA reminds firms of the need to have in place clear, detailed and up-to-date policies and procedures as well as regular tailored market abuse training for staff. Further, that firms should have systems and controls in place to manage conflicts of interest; for example by having a business function independent from the front office, such as the Compliance function, conducting market abuse surveillance.

Finally, the FCA highlights the importance of firms submitting STORs without delay, once they have a reasonable suspicion that an employee's conduct could constitute market abuse.

Amendments to the UK MLRs

In July 2021, HM Treasury issued a Consultation Paper proposing further amendments to the UK Money laundering Regulations (“MLRs”) to ensure that the UK continues to meet international standards, whilst also strengthening and ensuring clarity on how the UK’s AML regime operates. The consultation closed on 14 October 2021.

In June 2022, HM Treasury issued its response to the above-mentioned consultation paper, confirming the changes that will now be made to the MLRs.

A significant number of the forthcoming changes to the MLRs affect Cryptoasset firms; firms on the perimeter of financial services regulation; as well as enhancing information sharing and gathering powers for the authorities and law enforcement agencies.

However, the changes also include:

- ‘Proliferation financing’ considerations: Effective 1 September 2022, firms will be required to identify, assess and take effective action to mitigate proliferation financing (“PF”) risk. As such, firms will be expected to complete their own risk assessments of PF, alongside their current risk assessments for money laundering and terrorist financing. PF is defined as “the act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual use goods used for non-legitimate purposes), in contravention of national laws or, where applicable, international obligations”

- Reporting of material discrepancies in beneficial ownership: Effective April 2023, the obligation for firms to report discrepancies between information it receives about the beneficial owners of companies and that held on the public register (the “reporting discrepancy”) will be expanded to cover an ongoing business relationship. Since the introduction of the UK Money Laundering Regulations 2019, the reporting discrepancy has applied in respect to information identified at the onboarding stage; i.e. before establishing a business relationship with a customer. However, there was previously no clear obligation for firms to report any discrepancies identified after the onboarding stage.

The forthcoming changes aim to close this gap by making the reporting discrepancy compulsory to all stages of the ongoing business relationship, including when a firm is ‘refreshing’ its customer due diligence information. The ongoing reporting discrepancy obligation will apply only in respect of ‘material discrepancies’, with the government intending to publish a list of what it deems to be ‘material discrepancies’ shortly.

United States

SEC risk alert on MNPI

On April 26, 2022, the U.S. Securities and Exchange Commission's (SEC) issued a risk alert to provide investment advisers, investors, and other market participants with information with regards to notable deficiencies in relation to Section 204A ("Section 204A") of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 204A-1 (the "Code of Ethics Rule").

The Code of Ethics Rule requires the registered investment adviser's "access persons" (namely a supervised person who has access to non-public information regarding clients' purchase or sale of securities, to report personal securities transactions and holdings to a designated person typically, the Chief Compliance Officer.

The MNPI compliance issues observed by EXAMS staff included the following:

1. Inadequate policies and procedures concerning "alternative data." Deficiencies with managing "alternative data". This is includes data from non-traditional sources such as drone searches, card transaction data, social media etc.

2. Inadequate policies relating to the handling of "value-add investors." for example investors that are corporate executives or financial professional investors. The SEC argue these type of investors are more likely to possess MNPI.

3. Inadequate policies and procedures relating to the handling "expert networks.". Companies of individuals groups of who provide specialist information and research services. Common issues included lapses in monitoring discussions with expert networks consultants including untracked, unreviewed or unmonitored communications.

The issues related to the Code of Ethics Rule included the following:

As mentioned in the beginning of this article, The SEC felt that that advisers failed to identify "access persons" and therefore they failed to monitor them as such or did not account for "access persons" in the adviser's code of ethics.

Access persons were observed not to have to request pre approval to purchase certain investment, in particular IPOs. In general, failing around lack for reporting of personal securities transactions and holdings by access persons, little evidence of Compliance review of holdings and transaction reports and deficiencies relating to submission of holdings and transaction reports and finally evidence gaps in advisers' code of ethics regarding adequate content.

The SEC noted that supervised persons were not always provided a code of ethics and did not acknowledge any changes.
Firms should ensure:
1. Restricted stocks are not traded
2. Investment opportunities are offered to clients before the adviser or the Firm's staff have had the opportunity to trade them.

SEC risk alert on MNPI (*continued*)

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Enhanced ESG disclosures proposed by SEC

On 25 May 2022, the SEC proposed rule changes that would require SEC-registered advisers to include new narrative disclosures in their Form ADV Part 2A brochures relating to Environmental, Social and Governance ("ESG") factors considered in their investment process. In addition, registered advisers and exempt reporting advisers ("ERAs") would need to report census-like information in Form ADV Part 1A relating to an adviser's ESG strategies, including ESG-related reporting for each private fund identified in Part 1A. The SEC also reaffirmed that existing obligations under the Investment Advisers Act of 1940 (Rule 206(4)-7) (the compliance rule) which require investment advisers to address the accuracy of ESG disclosures and ensure portfolio management processes are consistent with disclosures.

The proposed rule concerning ESG disclosures is open for public comment until 16 August 2022. As proposed, advisers would be required to complete the new items in the Form ADV Part 1A and update their brochures one year after publication of an adopting release.

SEC short sale reporting scheme

On 26 April 2022, the period for public comment on the SEC proposed rule (rule 13f-2) requiring short selling reporting closed. The public comment period follows publication of the proposed rule in the Federal Register which, as indicated, requires institutional investment managers exercising investment discretion over short positions meeting specified thresholds to report on a proposed form SHO information relating to end-of-the-month short positions and certain daily activity affecting such short positions. The SEC has produced a factsheet with further details of the proposed rule.