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RQC Group Quarterly Regulatory Newsletter July 2021

Introduction

Welcome to our Q2, 2021 newsletter. This is part of a series that aims to provide you with a quarterly update of key regulatory issues affecting the UK/EU and the U.S.

After a lost summer of sport in 2020, the current calendar serves up a feast for sports fans. Whether it's – for instance - England, Scotland and Wales at Euro 2020, Andy Murray at Wimbledon, Lewis Hamilton at Silverstone or the Olympians in Tokyo, these occasions give us someone and/or something to root for. Of course, it's not just in sport where the UK is competitive. The domestic financial services industry competes against the rest of the world whilst at the same time having a level of inter-connectivity with its international colleagues and rivals that is unique to this industry. From a regulatory perspective, the goalposts have moved since the end of the Brexit transitional period – the UK is now able to make changes to its regulatory framework unilaterally and in the best interests of the domestic financial services sector. We explore how the UK might achieve this, in particular from the perspective of investment firms and fund managers. This newsletter also covers specific regulatory developments and initiatives, and enforcement action over the past quarter. All of these contribute to the 'bigger picture' – helping to deduce the longer-term direction of the UK's financial services industry.

In the U.S., the quarter was bookended by two new and significant appointments at the SEC. The quarter started out with Gary Gensler being confirmed as the new SEC Chair by the U.S. Senate on April 14 and being sworn into office on April 17. The topics discussed during his confirmation hearings may provide some insight into the focus areas the SEC sees as being more important to investors with the fresh topic of political spending disclosures being discussed along with climate change and governance.

Rounding out the quarter, it was announced on June 29 that Gurbir S. Grewal has been appointed as Director of the SEC's Division of Enforcement, effective July 26. Grewal currently serves as the Attorney General for the State of New Jersey, a role he has held since January 2018. While acting as AG in 2018, his office launched an "environmental justice" initiative and began bringing a number of environmental lawsuits against alleged polluters. This again may provide a hint into examination areas the Division of Enforcement may look to focus on.

As ever, we hope that you enjoy reading our newsletter and that you find it helpful. If you have any feedback please share it with your consultant.

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UK/EU - Ongoing Developments

Grasping the Opportunities for Change – Political and Regulatory Challenges for the UK Financial Services Industry

A transformation management practitioner might claim that when enacting change, a key challenge is orchestrating the correct type of change. Learning how to accept change is also important. These considerations are at the forefront of the minds of UK's legislators and regulators as they continue to furrow a post-Brexit pathway for the UK's financial services industry.

Although the UK was a significant contributor to the financial services framework adopted by the EU, it has been some time since the UK was able to make laws and rules unilaterally. An oft-quoted dichotomy is between evolution and revolution – will the UK make pragmatic adjustments to the framework that it more-or-less inherited from the EU on 31 December 2020, or will it rip up the rulebook and make wholesale changes?

Six months following the end of the transition period, there are a few clues as to the UK's direction.

The Trade and Cooperation Agreement between the UK and the EU, of 24 December 2020, is largely silent on financial services; among other things reciprocal access rights are not guaranteed. In the immediate aftermath, there was some cautious optimism regarding the timely establishment of 'equivalence' determinations, which would for instance enable UK MiFID investment firms and alternative investment fund managers to obtain EU right of access similar to that previously enjoyed under the 'passporting' regimes. However, these determinations have not been forthcoming, and there does not appear to be a timeframe for their implementation.

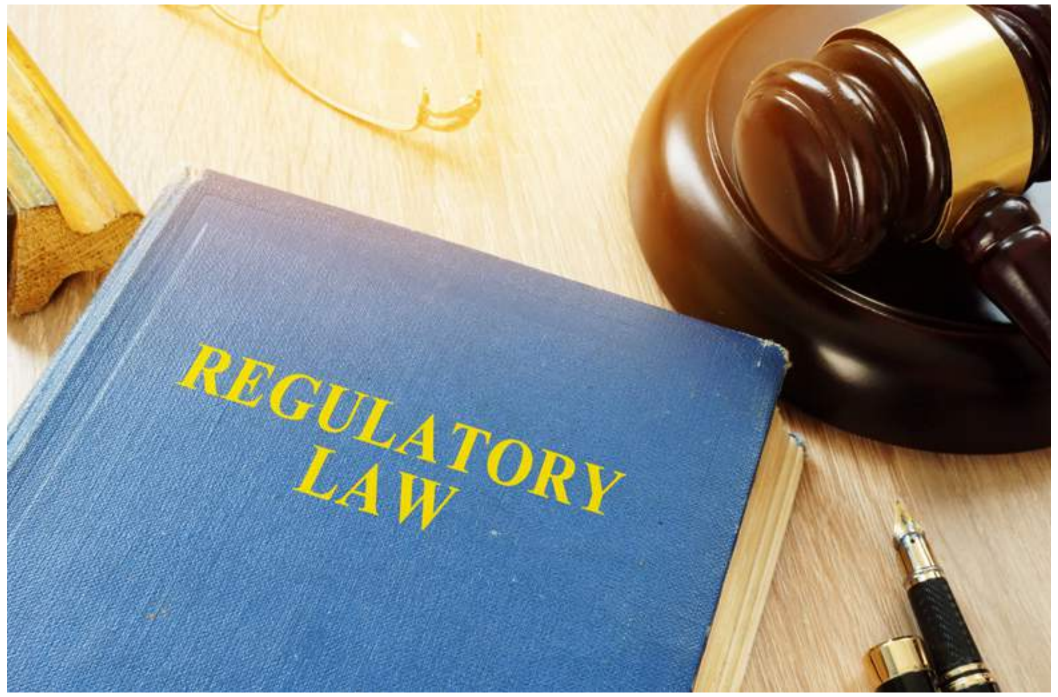
Even if they were to be adopted, the EU can unilaterally remove the rights for instance, if it feels that the UK has diverged too much from the EU's regulatory framework. This is unhelpful; analogous perhaps to a UK holidaymaker travelling to a COVID 'green listed' country only to have to scramble back to the UK once the country is downgraded to 'amber'.

Politically, therefore, reliance on the 'equivalence' determinations is arguably too much of a tightrope and therefore unworkable. If so, the legislators and regulators may feel that they do not need to be too constrained when enacting their 'change management' for financial services.

For investment firms and asset managers, that a bulk of the EU legislation that was brought onto the UK statute books on 31 December 2020 continues to apply. There are however some signs of divergence:

- The UK opted to not adopt EU legislation related to the EU's 2018 sustainable finance action plan, including the Sustainable Finance Disclosure Regulation ('**SFDR**') which took effect in March 2021. The UK's approach is to focus on the narrower topic of climate change, with a package of harmonised measures based upon the output of the Task Force on Climate-related Financial Disclosures ('**TCFD**') being introduced
- The UK is adopting a prudential framework for investment firms that is similar to that of the EU. However whilst the EU version took effect in June 2021, UK firms will become subject to the UK's equivalent on 1 January 2022
- The EU has made certain so-called 'quick fixes' to MiFID II as a result of the pandemic. The UK has not followed suit however regarding two topics within the 'quick fixes' – research and best execution disclosures – the FCA is proposing amendments that are more far reaching than the EU equivalents
- The changes to the EU's fund marketing regime which takes effect on 2 August 2021, shall not be adopted by the UK

Of course, the financial services marketplace is global and extends beyond the EU. In a classic case of Orwellian 'doublespeak', politicians tell us that 'Britain is open for business' and that includes the financial sector.



There are a few initiatives that seek to re-assert the UK's position as a global player.

In May 2021, the UK government's Taskforce on Innovation, Growth and Regulatory Report, published its findings. There is an emphasis on private sector investment, and FinTech/digitalisation, among other topics. Regarding regulatory change, reference is made to the UK's 'common law' system which is considered to be less rigid and detailed compared to the EU's 'codified' system. Reference is also made to certain aspects of the MiFID II transparency requirements being overly burdensome including the 65 data points for transaction reporting, and costs and charges requirements for non-retail clients. This effectively reverses the regulatory philosophy of MiFID II which introduced the more onerous requirements for wholesale firms in particular.

More recently, at the start of July 2021, HM Treasury published their 'Wholesale Markets Review' consultation document. It is recognised that the review is not about revolutionising the rulebook but about making it nimble and fit for purpose. However due to the extent

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and complexity of new regulation introduced by MiFID II in 2018, some rules have not delivered their intended benefits, have led to duplication and excessive burdens for firms, or have stifled innovation. The proposals relate to execution venues, markets (equity, fixed income, derivatives and commodities), market data, cross cutting issues and reporting. Regarding the latter, the transaction reporting regime is 'generally working well' but there is some confusion over who is responsible for reporting information and also the potential overlap with EMIR reporting. Investor protection reporting is also covered – for instance the FCA proposal to remove the requirement to produce best execution reports, and proposed secondary legislation related to costs and charges vis-à-vis distance communications, the removal of the requirement to report 10% portfolio losses to professional clients and the format of information for retail clients (paper based versus electronic format).

The UK government and the FCA are also looking into the UK fund regime from a taxation and regulatory perspective. The objective is to identify options which will make the UK a more attractive location to set up, manage and administer funds, and which will support a wider range of more efficient investments better suited to investors' needs. Among other considerations, it is perhaps hoped that this would 'break the inertia' of the onshore fund manager / offshore fund model.

The FCA has published a Consultation Paper on a new category of authorised open-ended fund, the long-term asset fund ('**LTAF**'). This new fund type would be designed to enable authorised funds to be set up to invest efficiently in long-term, illiquid assets, such as real estate, private equity and infrastructure.

The LTAF would initially be restricted to professional clients and 'sophisticated retail investors'.

The FCA contends that LTAFs would provide useful alternative investment opportunities for certain investors, able to bear the risks, in assets that are less liquid and potentially higher risk.

Taking all of this into account, where is the UK headed next? Echoing the sentiments in HM Treasury's Wholesale Markets Review, Nikhil Rathi, the FCA's CEO, has commented that 'the flexibility we've gained since Brexit will allow us to move nimbly and tailor rules to suit our markets, while maintaining high internationally consistent standards at least equivalent to the EU'. In the same speech, Mr. Rathi made reference to the UK's Temporary Permissions Regime which enables EU firms to continue to perform financial activities in the UK post-Brexit, pending a successful application to the FCA to become permanently authorised. Mr. Rathi states that these firms must be held to the 'same high standards' as UK firms and intimates that such firms will be properly vetted at the application stage as opposed to this process being a fait accompli.

So to conclude, from the FCA's perspective at least, the UK shall seek to revise the regulatory environment in the best interests of the domestic financial services industry whilst maintaining global regulatory standards – in terms of philosophy, approach and outcomes. If equivalence with the EU cannot be achieved, for instance because specific rule requirements do not quite match, then so be it.

Marketing funds in the EU – Pitfalls and Challenges

Marketing funds in the EU can be a complex proposition, in particular for firms seeking to market into this region. Will the new pre-marketing requirements simplify matters, or create more uncertainties?

The European Union fund marketing regime is often referred to as a patchwork quilt. Sometimes, the metaphor has positive, philosophical connotations – a person's life story is made up of many different elements, for instance. Many would argue that this is certainly not the case when it comes to trying to sell fund products to our European friends.

The EU Alternative Investment Fund Managers Directive – the basic text of which was finalised 10 years' ago – sought to 'harmonise' the internal marketing framework for alternative investment funds – but only where both the alternative investment fund manager and the alternative investment fund are domiciled in the European Economic Area. Furthermore, this framework is not available to smaller fund managers classified as a 'sub-threshold Alternative Investment Fund Manager ('**AIFM**')'. All other permutations are subject to a combination of baseline requirements detailed in AIFMD and – crucially – national private placement rules, or '**NPPRs**'. The application of the NPPRs varies significantly, and might include lengthy, time consuming and expensive registration processes, additional regulatory requirements and ongoing fees. In some circumstances, an NPPR is not available.

UK managers and marketers have historically been subject to this framework for some time. With the advent of the end of the transitional period came two key changes.

The first relates to the loss of the EU marketing passport, where a UK AIFM is managing an Alternative Investment Fund ('**AIF**') in jurisdictions such as Luxembourg or Ireland. This means that NPPR applies instead.

The second is the loss of passports under the Markets in Financial Instruments Directive ('**MiFID**'). This has complicated matters for those seeking to market from the UK and into the EU.

Firms have sought to resolve these issues in a number of ways, such as establishing a presence in the EU, marketing using an EU firm as a 'conduit', appointing a third-party EU placement agent and relying on 'reverse solicitation'. However, a chosen path may still contain uncertainties, and hence increased regulatory, legal and operational risk.

One challenge, that the EU is seeking to address, is the 'pre-marketing' phase i.e. where a fund is being planned and interest is being garnered, but a marketing application or notification has not been made. The introduction of a definition of 'pre-marketing' is part of the 'Cross-Border Funds Distribution' legislative package' ('**CBFD**') which takes effect on 2 August 2021. The concept applies to full-scope EU AIFMs pre-marketing EU AIFs in the EU, to professional investors. Hence, this does not directly apply to non-EU AIFs or non-EU AIFMs, pre-marketing to retail investors or pre-marketing conducted by sub-threshold AIFMs.

It is also worth noting that the FCA is not adopting CBFD. Instead, the FCA provides guidance on the parameters of 'marketing', as defined in AIFMD, versus promotional activity that takes place prior to the commencement of 'marketing'. For instance, providing 'a promotional presentation or a pathfinder version of the private placement memorandum' to a potential investor would not constitute 'marketing', so long as the potential investor is unable to subscribe to the fund at that time.

Returning to the CBFD, the new definition of 'pre-marketing', and the existing AIFMD definition of 'marketing' are as follows:

Pre-marketing	Marketing
Provision of information or communication, direct or indirect, on investment strategies or investment ideas	A direct or indirect
By an EU AIFM or on its behalf	Offering or placement
In order to test their interest in an AIF or a compartment which is not yet established, or which is established, but not yet notified for marketing in accordance with Article 31 or 32 [of AIFMD – this relates to marketing EU AIFs in the AIFMs home state and in another Member State respectively	At the initiative of the AIFM
In that Member State where the potential investors are domiciled or have their registered office	Of units or shares of an AIF it manages
And which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment	To or with investors domiciled or with a registered office in the Union

In addition, AIFMD has been amended to set out conditions for where marketing activity, as opposed to pre-marketing activity, has taken place:

The information:

- Contains sufficient information to allow investors to commit to acquiring units or shares of a particular AIF
- Amounts to subscription forms or similar documents whether in a draft or a final form, or
- Amounts to constitutional documents, a prospectus or offering documents of a not-yet-established AIF in a final form

Among other considerations, this indicates that a draft offering document can be provided to potential investors as part of pre-marketing, provided the aforementioned conditions are not met. In particular, the 'sufficient' information criteria indicates that a near final offering document with a 'draft' stamp might not constitute pre-marketing.

Where pre-marketing activity takes place there are certain requirements and obligations:

- Any information presented for pre marketing to potential professional investors:
    - is insufficient to allow investors to commit to acquiring units or shares of a particular AIF
    - does not amount to a subscription form or similar document (whether in draft or final form), and
    - does not amount to a final form constitutional document, prospectus or offering document for an established AIF

- Keep adequate documentation, for example dates on which pre-marketing took place, details of potential investors and a brief description of the pre-marketing information/communication
- Send an 'informal letter' to the AIFM's home state regulator within two weeks of commencing pre-marketing activities
- Once a pre-marketing notification has been made, any subscription to the AIF by a professional investor within an 18-month period will be considered to be as a result of formal marketing. This includes where no engagement with the investor took place during the pre-marketing phase

Where draft documentation is presented as pre-marketing with draft documents for potential professional investors the documents must not contain information sufficient to allow investors to take an investment decision. Furthermore the draft prospectus or draft offering documents must clearly state that the document does not constitute an offer or an invitation to subscribe to units or shares in the AIF; and the information presented in the documents should not be relied upon because it is incomplete and may be subject to change.

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On the face of it, this does not appear to affect non-EU AIFMs seeking to market AIFs in the EU. However, a recital within CBFD indicates that the pre-marketing requirements should not disadvantage EU AIFMs vis-à-vis non-EU AIFMs. It is therefore possible that EU countries will elect to 'gold plate' the requirements so that they apply to non-EU AIFMs (and also – potentially – to EU AIFMs managing non-EU AIFs).

- Establishment of 'marketing facilities' where an EU or a non-EU AIFM markets or intends to market an AIF to EU retail investors
- Processes regarding passporting de-notifications (EU AIFMs only)
- Regarding the content of marketing communications (EU AIFMs only)

Clearly, a key aim of CBFD is to harmonise the parameters of 'pre-marketing' within the EU. However, the EU contains a relatively small number of AIFMs compared to the UK and the US, for instance. For firms in these countries, and others outside the EU, arguably additional ambiguities are created as a result of the legislation effectively pushing 'gold plating' decisions to each country within the Union. Given the post-Brexit political environment, the EU's trade-off between investor protection and offering a choice of products to EU-based investors is arguably at a tipping point.

ESG Round-up

FCA announces climate-related disclosures for asset managers

On 22 June 2021, the FCA published a Consultation Paper that sets out the proposed climate-related disclosure framework for asset managers.

This is part of a UK Government initiative towards mandatory climate-related disclosures across the UK economy by 2025.

Under the proposal, all UK asset managers (and some investment advisers) with assets under management of £5 billion or above are required to make disclosures at two levels:

- Entity-level: A requirement to publish an annual entity-level report on how the firm takes climate-related risks and opportunities into account when managing investments, and
- Product or portfolio-level: A requirement to produce, annually, a baseline set of consistent, comparable disclosures in respect of the firm's products and portfolios, including a core set of metrics

The disclosures will be based upon the recommended disclosures of The Task Force on Climate-related Financial Disclosures ('**TCFD**'), which is a global body aiming to develop more effective climate-related disclosures that could promote more informed investment decisions and enable stakeholders to better understand climate-related risks and opportunities. The disclosures fall into 4 overarching categories:

- Governance: The framework includes specific recommended disclosures on the respective roles of the board and management
- Strategy: These recommended disclosures cover the nature of the climate-related risks and opportunities that the organisation has identified, the impact they may have, and the resilience to the organisation's strategy under different climate transition scenarios
- Risk management: TCFD calls for information on the processes the company has in place to identify, assess and manage climate-related risks, as well as transparency on how these are integrated into the organisation's wider risk management framework
- Metrics and targets: The framework calls for disclosure by companies on the metrics they use to monitor climate-related risks and opportunities, their Scope 1 and 2 emissions, and where appropriate, also their Scope 3 emissions. Moreover, the recommended disclosures cover any climate-related targets the company sets itself and performance against those targets

The requirements would take effect on 1 January 2022 for firms with assets under management of £50 billion or above and on 1 January 2023 for firms with assets under management of between £5 billion and £50 billion.

The FCA acknowledges certain similarities between this regime and the European Union's Sustainable Finance Disclosure Regulation ('**SFDR**') which took effect in March 2021, recognising that by focussing on climate-related issues the UK regime has a narrower remit. In part, this will minimise the impact of duplicative effort between the respective regimes.

Asset managers with assets under management of under £5 billion are out-of-scope, albeit such firms may nonetheless elect to adopt climate-related (or wider ESG) disclosures as a matter of commercial imperative. Conversely, the SFDR has no 'de minimis'. The rules will be set out in a new sourcebook within the FCA Handbook, the 'Environmental, Social and Governance' ('**ESG**') Sourcebook.

The Consultation Paper also details climate-related disclosures for life insurers and FCA-regulated pension providers. The FCA is seeking comments on the publication by 10 September 2021.

Separately, the FCA is also proposing to extend the application of its TCFD-aligned Listing Rule for premium-listed commercial companies to issuers of standard listed equity shares.

UK government appoints new independent group to tackle "green washing"

The UK government announced on 9 June 2021 that it has put together a new independent expert group, which will advise the government on standards for green investment.

The Green Technical Advisory Group ('**GTAG**') will oversee work on "Green Taxonomy" – a common framework setting the bar for investments that can be defined as environmentally sustainable. GTAG will provide non-binding advice to the government on market, regulatory and scientific considerations to develop a taxonomy suitable for financial as well as non-financial firms. The formation of the group is part of the UK's net-zero emissions effort. The group is membership-by-invitation. GTAG is expected to be convened for two years in the first instance, and issue a series of papers.

The Terms of Reference for GTAG can be found here.

EU Sustainable Finance – April Package

On 21 April 2021, the European Commission adopted a number of measures targeting the flow of money towards sustainable technologies and businesses.

The measures, which are part of the implementation of the 2018 sustainable finance action plan, affect a number of market participants including corporates, insurance companies, portfolio managers and investment advisers.

The measures include:

- Clarifying obligations on a financial firm when assessing its sustainability risks, such as the impact of floods on the value of investments – applies to UCITS management companies, AIFMs, insurance and reinsurance companies and MiFID firms
- When an adviser assesses a client's suitability for an investment, they now also need to discuss the client's sustainability preferences – applies to MiFID firms and insurance distributors
- Sustainability factors and sustainability-related objectives to be taken into account in the product oversight and governance process for products/instruments – applies to MiFID firms and insurance intermediaries/insurance companies that are product manufacturers or advisers.

These specific measures are anticipated to take effect in October 2022.

The measures follow the deadline for implementation of certain aspects of the Sustainable Finance Disclosure Regulation in March 2021 ('**SFDR**'). Neither the SFDR nor the measures adopted on 21 April 2021 apply in the UK, albeit UK firms that market financial products and services in the European Union might be affected.

The Investment Funds Prudential Regime – 6 Months To Go

Since the Summer of 2020, the FCA has published a series of policy documents with respect to the Investment Funds Prudential Regime ('**IFPR**') which takes effect on 1 January 2022. These documents set out the framework of IFPR, which will create a singular prudential framework for MiFID investment firms, the remit of which includes AIFMs with so-called 'top-up' permissions. It aims to apply the requirements in a proportionate manner reflecting a firm's size and business activities.

The documents include a series of Consultation Papers ('CP'). The first CP was published in December 2020 with the second CP following in April 2021. Most aspects of IFPR are covered in these two documents. A third and final CP shall follow in Q3, 2021.

In addition, in June 2021, the FCA published a Policy Statement discussing feedback received on the first CP and consequential changes to the framework. Among other aspects, the second CP covers the following topics:

- The 'own funds' requirement including the fixed overheads requirement
- The liquid assets requirement
- Remuneration requirements – click here to read our earlier article on this topic
- Risk management – the Internal Capital and Risk Assessment ('**ICARA**') process – click here to read our earlier article on this topic

Gap Analysis

The consolidation of a number of different prudential frameworks into one set of requirements will mean that the extent to which a firm's requirements will be amended will differ significantly from firm-to-firm. One indicator relates to a firm's current prudential category. Set out below are some considerations pertaining to firms falling into certain current categories.

- **Exempt CAD firms**

Exempt CAD firms (broadly speaking, firms that can only perform the MiFID activities of reception and transmission of orders, and investment advice) are currently subject to a 'light-touch' prudential framework. There is a regulatory capital requirement of no more than €50,000, and a requirement to submit returns to the FCA on the firm's financial and regulatory capital position. However, no other prudential requirements apply.

From 1 January 2022, Exempt CAD firms will be subject to a number of additional requirements, including the introduction of prudential requirements regarding liquidity, remuneration, risk management, group consolidation and public disclosures.

For many firms, a key difference will be with respect to regulatory capital. The regulatory capital will become the higher of:

1. £75,000 (Permanent Minimum Capital Requirement, or '**PMR**'
2. Fixed overheads requirement (1/4 of annual fixed overheads ('**FOR**')
3. For larger firms, a K-Factor requirement – new way of accounting for the potential harm that a firm could do to clients, markets and itself. For funds under management (which may include advisory

activity), the 'K-AUM' factor is 0.02% of funds under management/ advice ('**KFR**')

Recognising that for some firms this will represent a significant increase in regulatory capital, the FCA has proposed a 5-year transitional period, during which the PMR will increase from £50,000 to £75,000 (in annual increments of £5,000) and the FOR and KFR will both be a percentage of the calculated amount with the percentage increasing annually, for example 10% of the total during the calendar year 2023.

- **BIPRU firms**

BIPRU firms include businesses that conduct agency asset management and trading activity, and do not hold client money or safeguard assets. Such firms are currently subject to a regulatory capital requirement – the maximum of €50,000, a fixed overheads requirement and a credit/market risk requirement – a qualitative liquidity requirement, the internal capital adequacy assessment process ('**ICAAP**'), remuneration, regulatory reporting and disclosure requirements.

Under IFPR, BIPRU firms will become the higher of:

- £50,000 initially, rising in increments of £5,000 per year for 5 years, reaching £75,000 in 2027 (Permanent Minimum Capital Requirement, or '**PMR**')
- Fixed overheads requirement (1/4 of annual fixed overheads) ('**FOR**')
- For larger firms, a K-Factor requirement – new way of accounting for the potential harm that a firm could do to clients, markets and itself. For funds under management (which may include advisory activity), the 'K-AUM' factor is 0.02% of funds under management/ advice ('**KFR**')

In other words, the minimum capital requirement will change from €50,000 to £50,000 (rising to £75,000), the credit risk and market risk requirement will disappear, the FOR will remain and for certain firms the KFR will be introduced.

By way of derogation, matched principal brokerage firms that currently enjoy BIPRU status will become subject to a higher PMR (£750,000) and a mandatory KFR, regardless of firm size.

- **IFPRU firms**

A large variety of firm types currently fall into the IFPRU prudential category. Similar to other firm types, IFPRU firms will become subject to the PMR, FOR and KFR requirements. However, most IFPRU firms will have a PMR of either £150,000 or £750,000 dependent upon activities conducted.

Whilst IFPRU firms are subject to more stringent prudential requirements compared to other categories, there will nonetheless be some differences to the regime, for instance regarding consolidated groups, the replacement of the ICAAP with the ICARA, regulatory reporting, public disclosures and remuneration.

- **Collective Portfolio Management Investment ('CPMI') Firms**

A CPMI firm falls into the remit of the Alternative Investment Fund Managers Directive. It can manage an Alternative Investment Fund and it can also perform additional activities, such as managing segregated accounts, advising on investments and safekeeping assets.

A CPMI firm is subject to two prudential frameworks: a regulatory capital framework that forms part of AIFMD; and either the BIPRU or the IFPRU framework, dependent upon the scope of the additional activities.

From 1 January 2022, a CPMI firm will continue to be subject to two regimes, but with BIPRU or IFPRU replaced by the IFPR. As a consequence, the BIPRU or IFPRU considerations detailed above will also apply to a CPMI firm. From a regulatory capital perspective, this means that a CPMI firm will continue to be subject to two parallel requirements. Both regimes will include a requirement to calculate funds under management, therefore CPMI firms will need to separately consider the funds under management of the managing AIF business on one hand and the other investment management and advisory business on the other.

Per the current proposals, a CPMI firm will become subject to two remuneration codes: the current code for AIFMs, applying to AIF business, and the new IFPR code relating to other investment business. This might present challenges for firms that operationally do not separate out these business activities, such as firms managing AIFs and segregated accounts pari-passu, with all staff covering both activity types.

The two CPs published to date amount to precisely 800 pages, and as mentioned above there is a third CP yet to be published. Hence the aforementioned considerations represent a snapshot of aspects of the new framework. Many firms will encounter nuances and ambiguities in the run-up to 1 January 2022. Our advice to firms is to start working on IFPR transition projects sooner rather than later so that the applicability of the various aspects of the new regime can be ascertained ahead of time.

UK/EU - Regulatory News

Review of host Authorised Fund Management Firms

30 June 2021

The FCA has published the results of its review of Authorised Fund Managers ('**AFMs**') that delegate investment management to third-parties outside of its corporate group.

The review took place in 2019 and 2020 and involved visiting a sample of AFMs to review the effectiveness of their governance, controls and monitoring.

Aside from AFMs, these findings may be of interest to firms that outsource or delegate a key function, such as investment management, to a third-party.

The key findings are grouped into four categories:

1. Due diligence over third-party investment managers and funds

The FCA found that overall, firms performed poorly. Some firms relied on informal conversations to assess and understand proposals, as opposed to following a set process. There was evidence of not adequately addressing identified risks or inconsistencies and a lack of effective challenge to proposals and information from third-parties.

Furthermore, the FCA found AFMs to have a lack of knowledge when submitting fund applications to the FCA.

2. Oversight over third-party investment managers and funds

The FCA found that there was often a skills gap at an AFM, with staff not properly understanding the strategies and financial instruments employed. A number of firms also displayed poor oversight of the third-party managers.

3. Governance and oversight

A number of AFMs were unable to provide evidence of robust governance procedures, including ineffective challenge by non-executive directors, key decisions being taken outside of formal board meetings.

4. Financial resources

There were identified shortcomings with respect to an appropriate investment in systems, controls an people, the risk framework, reliance on professional indemnity insurance and/or parent support and stress-testing/wind-down planning.

Cryptoasset Round-up

26 June 2021

Consumer warning on Binance Markets Limited and the Binance Group

On 26 June 2021, the FCA advised that Binance Markets Limited, part of the Binance Group, a global cryptoasset exchange, is not permitted to undertake any regulated activity in the UK.

The FCA is also warning consumers of the dangers of investing in cryptoassets generally, noting that most firms offering cryptoassets products and services are not regulated by the FCA, and therefore consumers do not have recourse to the Financial Ombudsman Service or the Financial Services Compensation Scheme.

Consequently, Binance Group, which has an exchange in the Cayman Islands, can continue to offer cryptoasset exchange services to UK investors, where the asset is unregulated (e.g. cryptocurrencies such as Bitcoin, as opposed to financial derivatives where a cryptoasset is an underlying asset).

FCA publishes research into cryptoasset ownership

FCA has published a research report that looks at cryptoasset ownership, as well as the level of understanding among the public of these assets.

The research is based on three longitudinal studies, 2 quantitative studies and 1 qualitative study since October 2018.

Generally, cryptoassets fall outside the FCA's regulatory remit. Firms carrying out specific cryptoasset activities are required to register with the FCA with respect to compliance with money laundering and terrorist financing requirements. However, the FCA does not have consumer protection powers with respect to cryptoassets.

Cryptoassets can take many forms, the most well-known of which are the unregulated, transferable tokens, including Bitcoin, Ether and Ripple. The research focussed on unregulated, transferable tokens as these are the most likely to be in the public awareness.

The regulator estimates that ownership is up to around 2.3 million, up from around 1.9 million in 2020 or from 3.9% to 4.4% of adults.

78% of adults have now heard of cryptoassets. It also appears that less people now see these as a gamble: 38% of crypto users regard them as a gamble, down from 47% in 2020.

At the same time, the level of understanding of these token is varied. Bitcoin is the most well-known whereas others lag. Owners of cryptoassets were able to identify a definition of the instruments, whereas non-owners were less able to do so.

ESMA press release on its Annual Report

16 June 2021

ESMA's press release sets out the main items from its Annual Report. The Annual Report looks back over 2020, and compares this with a forward looking view based on its objectives.

The EU regulator cites its work on amendments to EMIR, as well as responding to Covid-19 and Brexit. Other items include enhanced peer review on the Wirecard case (accounting irregularities at a payment processing firm), the first common supervisory action on MiFID II requirements on appropriateness and execution requirements, liquidity risk in investment funds and many other regulatory initiatives.

It also mentions, among other things, its work on ESG, sustainable finance and taxonomy.

Joint letter with Prudential Regulation Authority on Delivery versus Payments clients

02 June 2021

The FCA and PRA have distributed a joint 'Dear Chief Risk Officer Letter' sharing observations on good practices related to monitoring and mitigating counterparty credit risks in relation to delivery vs. payment clients. Firms impacted by this should consider implementing good practices into their risk management controls and an update in response to steps taken on the back of the letter is expected by the regulators in Q4 2021.

The good practices relate to on-boarding of new accounts, credit risk framework, on-going oversight of clients, client exposure monitoring and escalation procedure.

HM Treasury to extend PRIIPs exemption for UCITS funds for five years

01 June 2021

HM Treasury announced that the current exemption for UCITS from the requirements of PRIIPs will be extended until 31 December 2026. Previously, the exemption for a UCITS to produce a PRIIPs KID was due to expire on 31 December 2021.

The Packaged Retail and Insurance-based Investment Products ('**PRIIPs**') Regulation has applied since 1 January 2018. The aim of the Regulation is to help investors to better understand and compare the key features, risk, rewards and costs of different PRIIPs, through access to a short and consumer-friendly Key Information Document ('**KID**').

UCITS are subject to a separate disclosure requirement currently.

Woodford Equity Income Fund investigation

28 May 2021

Nikhil Rathi, Chief Executive of the FCA wrote to Rt Hon. Mel Stride MP, Chair of the Treasury Select Committee updating on the progress of the investigation into the Woodford Equity Income Fund ('**WEIF**').

WEIF collapsed in June 2019, mainly due to investments in unlisted and less liquid companies. To date, £2.5 billion out of £3.7 billion of assets has been returned to investors.

Stating that the investigation has made 'substantial progress', the letter sets out that the FCA has interviewed 14 witnesses and has gathered 20,000 items of relevant material. If there is a case to answer, the FCA will instigate disciplinary proceedings.

Market Watch 67

28 May 2021

The FCA has published Market Watch 67, the latest in its series of newsletters on market conduct and transaction reporting issues.

Market Watch 67 focuses on market manipulation – a sub-set of market abuse that refers to a range of activities that seeks to unfairly distort the market.

Market manipulation can be detected in a number of ways, including the FCA's own surveillance of trading activity, via 'STORs' (suspicious transaction and order reports) submitted by regulated firms and via whistleblowing.

Market Watch 67 highlights instances where the FCA's own surveillance has detected market manipulation issues. These cover:

- Non-enforcement actions, including addressing potentially poorly designed algorithms at firms and addressing staff conduct at a firm where a trader was potentially engaging in 'spoofing' (using visible non-bona fide orders to deceive other traders as to the true levels of supply or demand in the market), and
- Enforcement outcomes including the Final Notices for Corrado Abbattista and Adrian Horn

Market Watch 67 also references Market Watch 59, whereby it highlighted that inaccurate reporting by firms when mapping 'short-to-long' client codes for order book activity could result in incorrect data being stored by trading venues. It is important for firms to check and ensure that they are maintaining accurate records of their order book data to meet their obligations. Furthermore, if they have not undertaken a risk assessment for market abuse a firm should conduct such an assessment to ensure their systems and controls for monitoring market abuse is robust.

ESMA proposes lowering the reporting threshold for net short positions to 0.1% on a permanent basis

13 May 2021

ESMA has published an opinion detailing a recommendation to the European Commission ("**EC**") to permanently lower the threshold to notify net short positions on shares to national competent authorities ("**NCAs**") from 0.2% to 0.1% 'as soon as possible'.

ESMA has examined the evidence gathered after its successive emergency decisions, beginning in March 2020, which lowered, for the first time, the notification threshold to 0.1% on a temporary basis. The notification obligation of net short positions at 0.1% of the issued share capital expired on 19 March 2021.

The analysis showed that a substantial amount of additional and essential information became available to NCAs due to the reporting of net short positions at the level of 0.1%. This additional transparency to NCAs of the real level of net short positions established in the market translates into an improved ability by NCAs to conduct market oversight. ESMA therefore considers it essential to lower the reporting threshold to 0.1% on a permanent basis.

The EC may adopt a delegated act modifying the notification threshold in Article 5(2) of the Short Selling Regulation.

Should this be adopted, the EC would follow the approach adopted by the FCA, which reduced disclosure requirement threshold from 0.2% to 0.1% in February 2021.

We suggest that firms reach out to their brokers, legal counsel or regulators from the jurisdictions of the financial instruments traded to ensure that they have the latest rules relating to short selling to ensure compliance with local regulation.

FCA research note on capital market liquidity

11 May 2021

On 11 May 2021, the FCA published a research note on the Covid-19 pandemic effects on the UK equity markets and bond ETFs, specifically the extent to which the liquidity of UK equity markets and bond ETFs were affected by the pandemic.

No-one can dispute that the pandemic has had a negative effect on UK economy. According to the paper, the UK's Gross Domestic Product ('**GDP**') fell by 9.9% in 2020. The year also saw some dramatic single-day falls in asset prices, e.g. on 12 March 2020, the FTSE 100 fell by more than 10%.

The report finds that for cash equities, measures of liquidity deteriorated to 2008 crisis levels. As an example, on the LSE, quoted spreads for FTSE 100 stocks increased from on average 4 basis points to 20 basis points on the 19 March, 2020. Spreads settled back to 5.5 basis points on average in November, and were back to approximately 4.85 basis points in February 2021.

A comparison with other major equities markets shows a very similar curve, with a spike in March 2020 and subsequent calming, but still remaining higher than before the World Health Organisation's announcement of a global pandemic. At the same time, the volatility index ('**VIX**') shows a curve that seems to follow closely the increase in spreads. Decrease in depth of markets is also shown to be affected.

Funding constraints and the link to liquidity is also reviewed, with funding liquidity said to be a determinant of market liquidity. For example, an increase in initial margins as well as margin calls impact funding available to provide liquidity. The study found that on the UK's primary derivatives exchange, ICE Futures Europe, LIFFE initial margins more than doubled from 5% pre-crisis to around 12%, where they remain as of December 2020.

The authors conclude that the variables associated with the deterioration in market liquidity are implied volatility indexes, a measure of funding constraints and margin requirements that might constrain available funding. They find that the deterioration in liquidity is mainly correlated with increases in the implied volatility index.

Insights from the 2020 Cyber Coordination Groups

29 May 2021

The increased threat of cyber risk has been a consistent hot topic in the financial services industry for many years, although never more important than in the last year due to the continued need for remote working arrangements across the globe. In its third annual Cyber Coordination Group ('**CCG**') insight publication, the FCA shared knowledge gained over the last year of discussions with members of its CCG members and detailed key insights, including good practice examples and broad cyber risks that span different sectors of the financial services. Current threats include:

- Ransomware
- Denial of Service (DoS)
- Targeting Cloud security
- Insider threat
- Supply chain security

Under "new ways of working", CCG members highlighted the increased cyber risk for firms due to remote workforces and therefore the need for effective monitoring and systems and controls to mitigate issues such as vulnerabilities in employees' home networks and opportunistic attackers looking to exploit the pandemic for their benefit. In addition, CCG members shared details of mitigation strategies for ransomware attacks, denial of service and cloud security.

All firms should assess their vulnerabilities, which may include using Cyber Security experts. With many firms losing millions of pounds to successful phishing attacks, the failure to ensure robust Cyber systems is not just a potential regulatory issue, but also one where the firm can suffer immense financial losses, which could impact on a firm's ability to operate.

Strengthening financial promotion rules for high-risk investments and firms approving financial promotions

29 April 2021

Following on from the FCA's Business Plan 20/21 which detailed the regulator's focus on consumer investments, the FCA has published a discussion paper asking for views on strengthening the FCA's financial promotion rules for high-risk investments, such as non-mainstream pooled investments.

Although the discussion paper primarily has a retail and consumer protection focus, there are a number of queries for wider industry participants to consider, including:

1. Whether there are any investments which are not currently subject to marketing restrictions, which should be?
2. Should the regulator change how certain types of investments are currently classified under the current financial promotion rules, consequently changing the level of restrictions that apply?
3. Are more requirements needed for firms to ensure accurate categorisation of retail clients where applicable?
4. Should consumers better categorise themselves?

In addition to the above, the FCA sets out questions for firms approving financial promotions relating to ongoing monitoring and client categorisation.

Shifting sands but the beach remains intact – FCA Proposes Changes to MiFID Research and Best Execution Requirements

28 April 2021

The Second Markets in Financial Instruments Directive ('**MiFID II**') has had an interesting journey. Originating in 2010, it sought to update the European regulatory framework for investment firms, reflecting the 2008 financial crisis and industry developments, including technological advances and commercial trends. The requirements eventually took effect in 2018 – 1 year behind schedule.

The legislative package is significantly larger than its predecessor and covers a sizeable number of topics. Given the sheer number of market participants impacted by MiFID II, it is perhaps inevitable that when put into practice, for any given firm certain elements would be more effective than others.

Brexit has further complicated matters. There are now two versions of MiFID II – the original European Union version and the UK version which as at 1 January 2021 was an almost carbon copy. For some time now, commentators have opined on the extent to which the respective frameworks will diverge in 2021 and beyond.

Although representing a small part of the framework, the FCA is proposing some changes related to research and best execution. If adopted, the changes will take effect during the second half of 2021.

Research – exemption for SME and FICC research proposed

Since 2018, under the MiFID II inducements framework, subject to certain exemptions, research services are either paid for by the firm itself or by agreeing a separate research charge with its clients. 'Bundling' of research and execution services – which was hitherto convention for certain asset classes – is not permitted.

This significant change arose out of a policy objective to improve accountability over costs passed onto clients and to improve price transparency vis-à-vis both research and execution.

However, the FCA has concluded that these benefits are outweighed by costs regarding small-cap firms. In particular, the changes have caused research coverage of such firms to decline and become lower in quality.

The proposal is to categorise research with respect to firms with a market capitalisation of less than £200 million as a 'minor non-monetary benefit'. In other words, it will be possible to either receive research for free, or to bundle (or, re-bundle) the research and execution costs.

The FCA also proposed creating an exemption where the research relates to fixed income, currencies and commodities ('FICC'). Such transactions are not typically paid for via commission payments but on the basis of a bid-offer spread. Therefore, re-bundling research and execution does not carry the same opacity risks as – for example – is the case for equities.

Finally, the FCA is creating exemptions regarding research provided by independent providers (i.e. where the provider does not also provide

execution services) and where the research is openly available.

Best Execution – proposal to remove publicly available annual reports

MiFID II aspired to improve investor protection and transparency in how firms execute client orders. The solution was to introduce publicly available reports focussing on the quality of execution. For execution venues the reports are known as '**RTS27**' reports. For investment firms, the '**RTS28**' reports have been an annual requirement for each calendar year from 2017 onwards.

The FCA has found that the policy goal has not been achieved. In particular, the reports are viewed by a very small number of market participants.

The FCA therefore proposed to remove the requirement to produce these reports.

ESMA highlights need for increased efforts on EMIR and SFTR data quality

15 April 2021

ESMA has published its final report on the European Markets Infrastructure Regulations ("**EMIR**") and Securitised Financing Transactions Regulation ("**SFTR**") data quality. The report covers the progress made to date in improving EMIR data quality for regulatory and supervisory use and concludes that, while good progress has been made, additional efforts are needed by national competent authorities ("**NCAs**") and ESMA to further improve EMIR data quality.

The Report is the first review of data quality since the introduction of the EMIR and SFTR reporting regimes. It also reviews the quality of data reported by trade repositories and gives an overview of actions taken by both ESMA and the NCAs to improve data quality.

EMIR Data Quality

Good progress has been made in recent years in improving the quality of EMIR data which allows it to be used for regulatory and supervisory purposes. ESMA and the NCAs have worked closely to achieve this and carried out numerous activities to improve data quality. However, the analysis of reported data indicates that there are a significant number of derivatives that are being reported late, not in line with the EMIR format and content rules, as well as derivatives that do not reconcile or are not reported altogether. The report shows that:

1. Based on early 2021 data, around 7% of daily submissions are being reported late by counterparties
2. Up to 11 million of open derivatives did not receive daily valuation updates
3. According to ESMA estimates, there tend to be between 3,2 and 3,7 million of open non-reported derivatives on a given reference date during 2020, and
4. Around 47% of open derivatives (totalling circa 20 million open derivatives) are unpaired

The report also contains jurisdictional breakdowns of several data quality issues.

SFTR Data Quality

ESMA, in view of the fact that the SFTR reporting regime was only launched recently, presents a limited overview of SFTR data quality in terms of key data quality indicators, such as rejection rates, as well as an overview of the data reporting landscape. In view of the complexity and scale of SFTR reporting, it is important that all relevant stakeholders – counterparties, TRs, NCAs and ESMA – set aside sufficient resources to monitor data quality thoroughly.

Like EMIR, Brexit has also had a significant impact on the SFTR reporting landscape. There has been nearly 50% decline in the number of open SFTs immediately following Brexit. However, the number of open SFTs has had an increasing trend since.

ESMA will publish its Data Quality Report annually.

We suggest that firms check the quality of the EMIR reporting even if this is delegated to another party to ensure accuracy of submissions. With the implementation of 'EMIR Refit', firms should also ensure that they and their funds are classified correctly and that appropriate calculations are undertaken for derivatives traded to ensure that they meet any clearing notification requirements.

Financial Stability Board ("FSB") publishes Peer Review of UK remuneration regime

14 April 2021

The report highlights how the UK closely follows the FSB Principles and Standards ('**P&S**') for Sound Compensation Practices, as well as the effectiveness of how the FCA works and shares information with the PRA.

The UK is the first FSB member to be assessed by peers on the effectiveness of its remuneration reforms in the financial sector since the financial crisis and its consistency with the P&S. Over the last eighteen months, the UK Authorities (PRA, FCA) and HM Treasury have worked together to provide the FSB Peer Review team with comprehensive information on the UK's regulatory and supervisory approach to remuneration. This has involved regular dialogue with the review team and a number of interviews.

The report recognises the emphasis UK authorities place on the importance of remuneration for setting incentives that are consistent with effective risk management and prudent decision making, to support the long-term viability of firms. As the report notes, in combination with the UK Senior Managers and Certification Regime ('**SMCR**'), the remuneration regime has helped firms to map responsibilities, which has resulted in more consistent and effective implementation of remuneration practices. This report is a positive assessment of the FCA and its role in the promotion of international standards, our commitment to the SMCR and high standards of conduct and culture.

ESMA updates its Legal Entity Identifier ("LEI") statement

13 April 2021

ESMA has published an updated statement on the implementation of LEI requirements for third-country issuers under the SFTR reporting regime.

The updated LEI statement maintains ESMA's position as described on 6 January 2020 and provides an extended timeline for the reporting of LEIs of third-country issuers of securities used in Securities Financing Transactions ('**SFTs**') until 10 October 2022. The updated statement also sets out the expectations towards Trade Repositories and counterparties, as well as the relevant supervisory actions to be carried out by authorities.

ESMA report highlights liquidity concerns for AIFs

08 April 2021

ESMA has published a statistical report looking at the European AIF universe.

They find that the EU AIF universe expanded to reach EUR 6.8tn in net asset value ('**NAV**') at the end of 2019, a 15% increase from 2018. The increase is due to new AIF launches as well as positive valuation effects. AIFs accounted for 40% of the EU fund industry at the end of 2019. The majority of shares in AIFs are owned by professional investors, but retail investors do share 15% of the overall NAV, being most active in fund of funds (28%) and real estate funds (21%).

The report highlights liquidity as a potential area of concern in a short horizon. Liquidity offered can tend to be greater than liquidity of assets, especially for FoFs, and this could lead to a mismatch in the event of large redemptions. Mismatching liquidity is also a concern for RE funds across all time horizons, due to the illiquidity of real estate assets.

The EU hedge fund sector is at 5% of NAV. Although when measured by gross exposure, hedge funds account for 62% of AIFs due to reliance on derivatives trades. They are also highly leveraged, and while not showing the same liquidity mismatch, the report states financing risk as a risk due to overnight funding strategies. At the time covered by the report, the hedge fund industry was heavily concentrated in the United Kingdom, with more than 75% of the NAV managed by UK AIFMs.

Interestingly, the majority of hedge funds are domiciled outside the EU and sold through NPPR. The report states that EU member states can allow non-EU asset managers to market AIFs through NPPR, albeit they cannot subsequently be passported to other EU member states.

The market for non-EU AIFs is large, with the NAV of non-EU AIFs marketed under NPPR amounting to EUR 1.2tn or 1/5 of the AIF market. NPPR marketing seems to be concentrated in a small number of member states with the UK registering twice the amount of funds marketed under NPPR to Luxembourg, which is second on the list, just before Finland. 98% of investors in these funds are professional investors. Hedge funds marketed under the NPPR are predominantly domiciled in the Cayman Islands, 'other AIFs' marketed under the NPPR are predominantly US-based exchange-traded funds (ETFs). Overall, risk profiles for NPPR funds are comparable to EU AIFs. However, the geographical investment focus is different as NPPR funds invest predominantly in non-EU areas.

The report notes that the period covered is 2019, when the UK asset management industry was part of the single market and the report includes UK data.

FCA publishes financial promotions quarterly data

06 April 2021

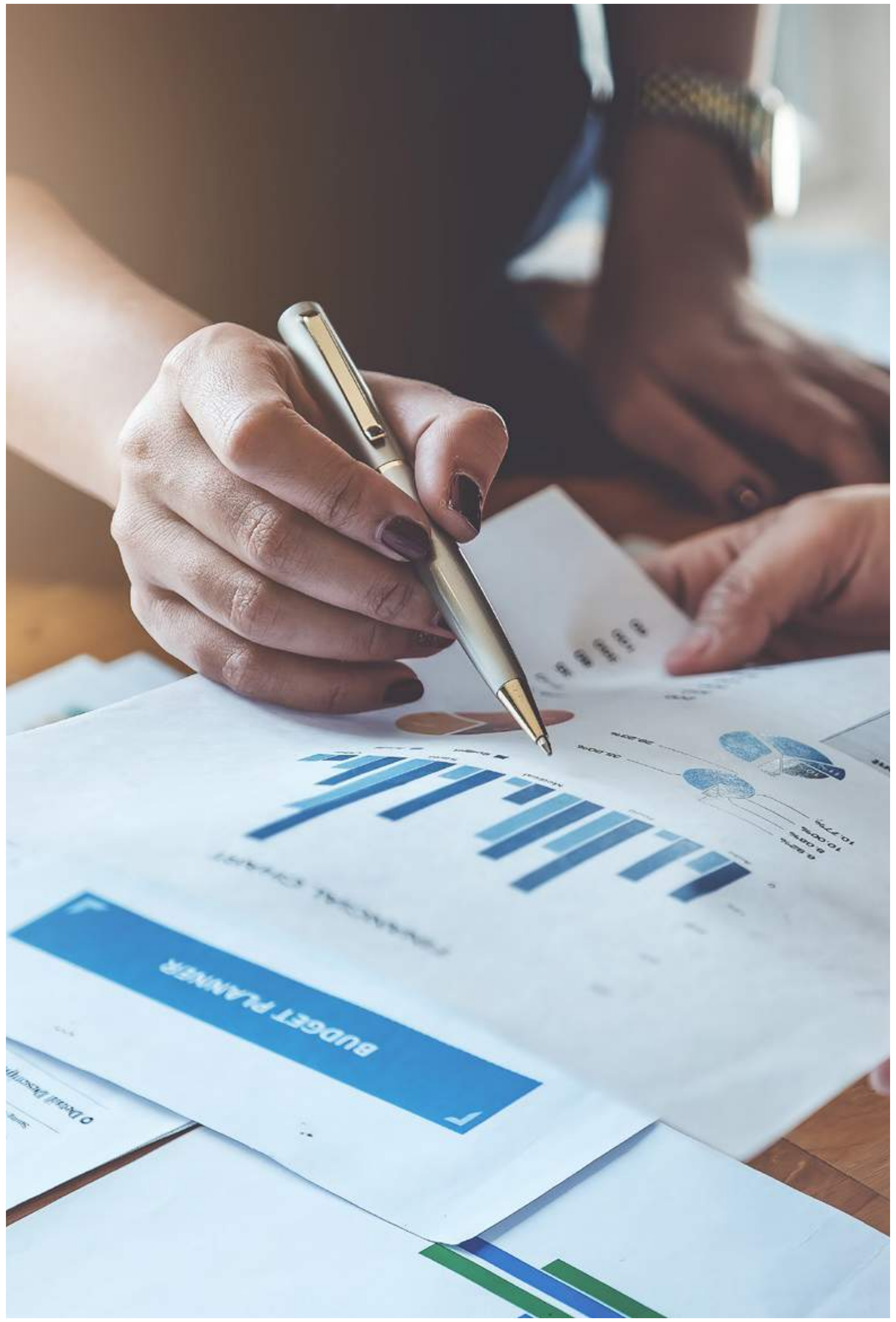
The FCA has a new website on financial promotions quarterly data. The FCA undertakes reviews of firms' financial promotions, mainly identified through sources such as consumer referrals and firm referrals. If an advert is concluded to be in breach of the FCA's rules, the firm that has published the advert is contacted and asked to withdraw or change it. The FCA may also ask if any customers may have acted on the advert, and if so, the regulator may ask the firm to take appropriate action to reduce any harm to consumers.

The regulator thus collects data and statistics on non-compliant financial promotions and from 2021, the Regulator will publish its data quarterly in the interest of transparency.

A reminder for firms why it is important that they apply the relevant rules and guidance for financial promotions. In Q1 2021, the FCA reviewed 441 financial promotions, which includes promotions identified through both complaints and through proactive work. The complaints are mainly related to the retail sectors, with retail lending comprising nearly 50% of cases, retail investments just under 30% and retail banking just under 20% of cases.

45% of the complaints on promotions came from consumers; 27% from internal FCA sources, 15% from other UK regulators and 13% from other sources.

38 of the cases resulted in 105 promotions being amended or withdrawn through our interaction with authorised firms. 75% of these amended promotions relate to website or social media adverts.



ESMA updates Q&A on MiFID and MiFIR transparency topics

06 April 2021

ESMA has introduced changes to one of its Q&As on tick sizes to reflect the amendment introduced in Article 49(1) of MiFID II which excludes Large in Scale transactions from the mandatory tick size regime.

The aim of the minimum tick size regime is to ensure the orderly functioning of the markets, and its application extends to all orders submitted to trading venues including limit orders resting on an order book, and orders held in an OMS. However, the minimum tick size regime does not apply in certain cases:

- transactions executed in systems that match orders on the basis of a reference price as per Article 4(1)(a) of MiFIR, or to
- negotiated transactions as per Article 4(1)(b) of MiFIR, and
- large-in-scale orders that are matched at the mid-point of bid and offer prices - as per Art 49(1) of MiFID, as amended

The purpose of ESMA's Q&As on market structures issues is to promote common supervisory approaches and practices in the application of MiFID II and MiFIR. They provide responses to questions posed by the general public and by market participants in relation to the practical application of level 1 and level 2 provisions to transparency and market structures issues.

UK/EU - Enforcement

FCA charges Ian Hudson with fraudulent trading and carrying on regulated activities without authorisation

17 May 2021

The FCA has commenced criminal proceedings against Ian James Hudson, following an investigation. Mr Hudson appeared at Westminster Magistrates' Court in relation to three charges. This includes carrying on a business, namely Richmond Associates, with the intention to defraud creditors and carrying on regulated activities namely advising on investments and accepting deposits without authorisation.

The FCA alleges that between 1 January 2008 and 31 July 2019, Mr Hudson advised on investments and purported to invest deposits received by him from clients on their behalf. At no point during this time was he authorised by the FCA to undertake these financial services, as is required by law.

Further, while Mr Hudson told clients that the money they deposited with his business, Richmond Associates, would be invested in various financial vehicles or otherwise put to specific uses, this was not always the case.

FCA publishes a first supervisory notice for 2021, re FXBFI Broker Financial Invest Ltd, trading as 101investing.com

10 May 2021

FXBFI is a Cypriot company, which provided contracts for difference ('**CFD**') trading on its platform which was accessed via its website. The FCA received complaints regarding the company and its selling tactics from about September 2020, with an increase in complaints during 2021.

Complaints include use of misleading financial promotions, typically advertised online and with unrealistic promises of significant profits. The company frequently engaged with customers over the phone, at which point the sales team failed to ensure that customers understood about the nature and risks of trading CFDs. Complaints were also raised against pressurising sales tactics to re-invest and failure to allow clients to withdraw funds.

Further, FXBFI does not have regulatory permission to advise on investments, nevertheless customers described the sales team staff providing advice on sectors to invest in as well as tax implications.

In its supervisory notice, dated 27 April 2021 and published on 10 May 2021, the regulator requires FXBFI to notify all of its clients resident in the UK that it is no longer able to provide investment services to them and that it will be taking all reasonable steps to return all balances held by FXBFI on their behalf. The company is also required to place a notice on all of its websites, and on its trading platform, stating that the firm is no longer permitted to provide regulated financial services to residents in the UK.

The FCA considers that FXBFI has breached Principle 7 ('Communications with clients') by failing to ensure that its marketing communications are fair, clear and not misleading. The firm also breached Principle 6 ('Customers' interests and treating customers fairly') by failing to assess suitability of instruments provided to clients; failure to provide appropriate information in good time to clients; failure to act honestly and fairly in accordance with best interests of its clients and not actioning request for redemptions; and failure to handle complaints in an appropriate manner.

FCA fines Sapien Capital Ltd for serious financial crime control failings in relation to cum/ex trading

06 May 2021

This is the first FCA case in relation to cum/ex trading, dividend

arbitrage and withholding tax ('**WHT**') reclaim schemes. Between 10 February 2015 and 10 November 2015 Sapien failed to have in place adequate systems and controls to identify and mitigate the risk of being used to facilitate fraudulent trading and money laundering in relation to business introduced by the Solo Group.

The Solo trading was characterised by what appeared to be a circular pattern of extremely high value trades undertaken to avoid the normal need for payments and delivery of securities in the settlement process. The trading pattern involved the use of Over the Counter ('OTC') equity trading, securities lending and forward transactions, involving EU equities, on or around the last day securities were cum dividend.

The FCA investigation found no evidence of change of ownership of the shares traded by the Solo clients, or custody of the shares and settlement of the trades by the Solo Group.

The way these trades were conducted by the Solo Group and their clients, in combination with their scale and volume, were highly suggestive of financial crime, and appear to have been undertaken to

create an audit trail to support withholding tax reclaims in Denmark and Belgium.

In addition, Sapien failed to exercise due skill, care and diligence in applying anti-money laundering policies and procedures and in failing properly to assess, monitor and mitigate the risk of financial crime in relation to clients introduced by the Solo Group and the purported trading.

Mark Steward, FCA Director of Enforcement and Market Oversight, stated: 'These transactions ran money laundering and other financial crime risks which Sapien incompetently failed to see. 'The FCA expects firms have systems and controls that test the purpose and legitimacy of transactions, reflecting scepticism and alertness to the risk of money laundering and financial crime, and failures here constitute serious misconduct.' The firm was fined £219,000, after a 30% discount for cooperating, although they were given a further reduction due to financial hardship.

The FCA commences criminal proceedings against Larry Barreto and Tassib Hussain

23 April 2021

The proceedings relate to an offence of conspiracy to commit fraud by false representation involving both defendants and 2 further offences by Larry Barreto of carrying on regulated activities without authorisation. Larry Barreto traded as Barreto and Partners, an unauthorised financial services firm based in Nottingham. Tassib Hussain is an accountant who ran Keystone Chartered Accountants also based in Nottingham.

The fraud charges relate to a series of mortgage applications made between January 2015 and March 2018. The alleged conspiracy involved mortgage clients of Mr Barreto. If Mr Barreto concluded that they had insufficient income to justify the mortgage they required, he would charge the client a fee which he would then pay in cash to Mr Hussain, to create the false self-employment and employment documentation to support mortgage applications for clients with insufficient income. The total value of the mortgages applied for was circa £3.8 million.

FCA stops FXVC offering CFDs to UK customers

16 April 2021

The FCA has acted to stop a Cypriot based firm, Finteractive Limited (trading as FXVC), from offering high risk contracts for difference ('**CFDs**') to UK investors.

FXVC used a variety of inappropriate techniques, including misleading financial promotions which appeared to offer consumers the opportunity to purchase shares in a well-known company and failed to mention that they were actually promoting CFDs.

Many of the FXVC's customers were unclear about the nature of the investments that they were being persuaded to make and the risks involved in trading in CFDs. The firm used pressure tactics, described by one customer as 'relentless', to encourage consumers to invest ever increasing sums of money. Some customers were even encouraged to declare they were professional investors despite not meeting the necessary criteria for such categorisation.

The FCA has stopped FXVC conducting any regulated activities in the UK and required the firm to close all trading positions and return the money to customers.

FXVC operates in the UK under the Temporary Permission Regime ('**TPR**') put in place for firms who used to operate in the UK under a passport and who wish to continue to operate here following the UK's exit from the European Union. These firms operate under the TPR until their application for full authorisation by the FCA can be considered.

FCA bans and fines financial adviser £68,300 for lacking honesty and integrity

15 April 2021

The FCA has banned Simon Varley from working in financial services and fined him £68,300 for knowingly performing a controlled function without approval and for providing investment advice to retail customers when he knew he was not qualified or approved to do so.

The FCA also found that Mr Varley failed to act with integrity as a Director (CF1) and Compliance Oversight (CF10) controlled function (CF) holder and is therefore not a fit and proper person.

Mr Varley worked at Dickinsons Financial Management Limited ('**Dickinsons**'), a small financial advisory firm where he held a customer adviser function ('**CF30**') until January 2013. Following the

RQC GROUP

Retail Distribution Review, the FCA introduced rules requiring that advisers hold a minimum level of qualification to be approved for a CF30 function. Although his CF30 approval was removed in January 2013 by the FCA at his request, Mr Varley still continued to advise retail customers between January 2013 and September 2017.

Mr Varley repeatedly misled his fellow directors by providing false information in board meetings about sitting and passing the relevant exams required for him to continue advising, and falsely claiming that he had applied to the FCA for approval as a CF30 but that the FCA had not updated the Financial Services Register. In fact, no application was ever made. Mr Varley also knowingly facilitated the provision of false information to Dickinsons' PII ('**Professional Indemnity Insurance**') providers about the qualifications he held, in order to be insured to advise retail investors after 2013.

As part of his CF10 function, Mr Varley was required to provide regulatory information to the FCA in Dickinsons' Retail Mediation Activities Returns. In discharging this responsibility, Mr Varley knowingly misled the FCA into believing that only 1 person at Dickinsons was providing retail investment advice to customers instead of 2. He also provided explanations to the FCA that were untrue to conceal his own misconduct.

The false information provided to Dickinsons' PII providers and to the FCA created the potential risk of loss to consumers, as Mr Varley was not qualified to provide the advice and, subsequently, his advice was deemed to be uninsured. Mr Varley's actions led to Dickinsons going into voluntary liquidation and being dissolved.

USA - Ongoing Developments

The SEC's Division of Examinations' review of ESG investing

The SEC's Division of Examinations (the '**Division**') has issued a Risk Alert highlighting observations from recent examinations of investment advisers, registered investment companies, and private funds offering environmental, social, and governance ('**ESG**') products and services. The Risk Alert is intended to highlight risk areas and assist firms in developing and enhancing their compliance practices.

As investor demand has grown, investment advisers and funds have expanded their approaches to ESG investing and increased the number of product offerings across multiple asset classes. This rapid growth in demand, increasing number of ESG products and services, and lack of uniform and precise ESG definitions has created some confusion among investors where investment advisers and funds have not clearly and consistently articulated how they define ESG and how they use ESG-related terms.

Examinations of Investment Advisers and Funds

Division staff will continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches, and whether they have adopted policies, procedures and practices that are consistent with these disclosures.Exams of firms claiming to engage in ESG investing will focus on, among other matters, the following:

1. Examinations of Investment Advisers and Funds

Examinations will include a review of:

- policies, procedures, and practices related to ESG and the use of ESG-related terminology
- due diligence and other processes for investments in view of the firm's disclosed ESG investing approaches
- whether proxy voting decision-making processes are consistent with ESG disclosures and marketing materials

2. Performance advertising and marketing

Examinations will include a review of:

- the firm's regulatory filings
- websites
- reports to sponsors of global ESG frameworks, to the extent the firm has communicated a commitment to follow such frameworks
- client presentations
- responses to due diligence questionnaires, requests for proposals, and client/investor-facing documents, including marketing materials

3. Compliance programs

Examinations will include a review of written policies and procedures and their implementation and oversight by compliance.

Staff Observations

Division staff observed instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks.

At a high level, staff observed that compliance programs were less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures. In addition, the staff noted weaknesses in compliance controls regarding performance metrics included in marketing materials (such as risk, returns, and correlation metrics), and a lack of compliance review of the data underlying those measures.

1. Inconsistent portfolio management practices with disclosures about ESG approaches

The staff observed portfolio management practices that differed from client disclosures in required disclosure documents and other investor-facing documents. For example, the staff observed:

- lack of adherence to global ESG frameworks where firms claimed such adherence
- fund holdings predominated by issuers with low ESG scores where such predominance appeared inconsistent with a firms' stated approach

2. Inadequate controls to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions

The staff noted weaknesses in policies and procedures governing implementation and monitoring of clients' ESG-related directives. The staff observed that advisers had inadequate systems and controls around:

- implementation and monitoring of clients' negative screens (e.g. prohibitions on investments in certain industries, such as alcohol, tobacco, or firearms)
- consistently tracking and updating clients' negative screens leading to the risk that prohibited securities could be included in client portfolios

3. Proxy voting inconsistent with advisers' stated approaches.

Staff observed inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices. For example, the staff observed:

- public statements that ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value, while internal guidelines generally did not provide for such analysis
- public claims regarding clients' ability to vote separately on ESG-related proxy proposals, but clients were never provided such opportunities

4. Unsubstantiated or potentially misleading claims regarding ESG approaches

The staff observed unsubstantiated or otherwise potentially misleading claims regarding ESG investing. For example, the staff noted:

- marketing materials touted favorable risk, return, and correlation metrics related to ESG investing without disclosing material facts regarding significant expense reimbursement received from the fund-sponsor, which inflated returns for those ESG-oriented funds
- unsubstantiated claims regarding substantial contributions to the development of specific ESG products, when, in fact, their roles were very limited or inconsequential

5. Inadequate controls to ensure that ESG-related disclosures and marketing are consistent actual practices

The staff observed inconsistencies between actual firm practices and ESG-related disclosures. For example, the staff observed:

- a lack of adherence to global ESG frameworks despite claims to the contrary
- unsubstantiated claims regarding investment practices
- a lack of documentation of ESG investing decisions and issuer engagement efforts
- failures to update marketing materials timely (e.g. an adviser continuing to advertise an ESG investment product or service it no longer offered)

6. Compliance programs inadequately addressing relevant ESG issues

The staff observed firms substantially engaged in ESG investing that lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight.

The staff also noted a lack of policies and procedures to ensure firms obtained reasonable support for ESG-related marketing claims, and observed inadequate policies and procedures regarding oversight of ESG-focused sub-advisers.

Staff Observations of Effective Practices

While the staff observed compliance deficiencies and weaknesses relating to ESG investing, some investment advisers and funds did have in place disclosures that accurately conveyed material aspects of the firms' approaches to ESG investing.

Some of the practices the staff observed include:

- disclosures that were clear, precise and tailored to firms' specific ESG approaches, and which aligned with the firms' actual practices
- policies and procedures addressing ESG investing and covering key aspects of the firms' relevant practices, including specific documentation to be completed at various stages of the investment process (e.g. research, due diligence, selection, and monitoring)
- compliance personnel that are knowledgeable about the firms' specific ESG-related practices

The Division encourages all market participants promoting ESG investing to evaluate whether disclosures, marketing claims, and other public statements made to clients and potential clients related to ESG investing are accurate and consistent with actual firm practices.

Firms should also ensure that their approach to ESG is implemented consistently throughout the firm and are adequately addressed in the firm's policies and procedures. Finally, firms should take steps to document and maintain records relating to the various important stages of the ESG investing process.

USA - Regulatory News

SEC approves adjustment for inflation of "qualified client" thresholds

23 June 2021

Section 205 of the Investment Advisers Act of 1940 (the 'Advisers Act') generally prohibits a registered investment adviser from entering into any investment advisory contract with a client that provides for compensation to the adviser be based on a share of capital appreciation of the client account (a 'performance fee'). Rule 205-3 provides an exemption from the general performance-based fee prohibition for advisers to private funds whose investors are "qualified clients" meeting certain financial thresholds.

On June 17th, the SEC issued an order adjusting the dollar amount thresholds for clients of registered advisers to be "qualified clients" under rule 205-3 of the Advisers Act. The SEC's order amends the rule to increase the assets-under-management test from $1,000,000 to $1,100,000, and the dollar amount of the net worth test from $2,100,000 to $2,200,000.

The Order will be effective on August 16, 2021.

The restriction on performance fees applies to registered advisers only, and excludes exempt reporting advisers, foreign private advisers, family offices, etc. To the extent that contractual relationships are entered into prior to the order's effective date, the dollar amount test adjustments in the order would not generally apply retroactively.

NFA reminds members of disclosure and reporting requirements when engaging in virtual currency activities

03 June 2021

Noting the recent volatility in the virtual currency market, the NFA recently reminded Members engaging in virtual currency activities that they must fulfil certain ongoing disclosure and reporting requirements.

Commodity pool operators ('**CPOs**') and commodity trading advisors ('**CTAs**') that engage in activities related to virtual currencies or virtual currency derivatives must comply with the disclosure requirements established in NFA's Interpretive Notice entitled Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities.

The NFA also requires CPOs and CTAs that execute transactions involving virtual currencies or virtual currency derivatives to immediately notify the NFA by amending its Annual Questionnaire.

CFTC publishes updated responses to FAQs regarding Regulation 4.27 and Form CPO-PQR

26 May 2021

In October 2020, the CFTC adopted a Final Rule amending its Form CPO-PQR, a filing designed to collect data from registered commodity pool operators ('**CPOs**') about each of their commodity pools ('**Pool**'), as well as the provision requiring it, Regulation 4.27.

Subsequently, the CFTC has updated responses to frequently asked questions regarding Form CPO-PQR and Regulation 4.27. The purpose of the updated FAQs is to provide guidance to CPOs filing the recently revised Form CPO-PQR, and it answers several questions specific to the changes made by the Final Rule.

US-UK Regulatory Cooperation

24 May 2021

On May 24, the US Treasury Department issued a joint statement covering the recently held fourth meeting of the US-UK Financial Regulatory Working Group ('**Working Group**'). Participants included officials and senior staff from both countries' treasury departments, as well as regulatory agencies including the Federal Reserve Board, CFTC, FDIC, OCC, SEC, the Bank of England, and the Financial Conduct Authority.

The Working Group discussed, among other things:

1. financial sector implications of the UK's withdrawal from the EU;
2. "cooperative efforts to promote the free flow of cross-border financial services data crucial for effective financial sector regulation and supervision";
3. regulatory fragmentation and data localization risks;
4. the Financial Stability Board's work on non-bank financial intermediation, which involves active engagement from both US and UK authorities; and
5. the management of climate-related financial risks and other sustainable finance issues.

Working Group participants will continue to engage bilaterally on these issues and others ahead of the next meeting planned for this fall.

RQC GROUP

Effective date for NFA rules establishing CPO notice filing requirements

13 April 2021

The NFA has adopted Compliance Rule 2-50 and a related Interpretive Notice entitled Compliance Rule 2-50: CPO Notice Filing Requirements, which require commodity pool operator ('**CPO**') Members to file notice with NFA when an event affects a commodity pool's ability to fulfill its obligations to investors.

While certain elements of NFA Compliance Rule 2-50 are already reported to the NFA, the update will change the manner and timeframe of such reporting.

In summary, the Rule requires CPO Member to promptly notify the NFA if it:

- Operates a commodity pool that is unable to meet any margin call
- Operates a commodity pool that is unable to satisfy redemption requests in accordance with its subscription agreements
- Operates a commodity pool that has halted redemptions and the halt on redemptions is not associated with pre-existing gates or lockups, or a pre-planned cessation of operations
- Receives notice from a swap counterparty that a pool the CPO Member operates is in default

This rule and Interpretive Notice will become effective on June 30, 2021.

USA - Enforcement

CFTC charges Chicago Commodity Pool Operators and former Chief Portfolio Manager with fraud and supervision failures

27 May 2021

The CFTC announced charges in federal court against Chicago commodity pool operators ('**CPOs**') LJM Partners Ltd and LJM Funds Management Ltd, (collectively '**LJM**'), their Chairman, owner and registered associated person ('**AP**') Anthony J. Caine of Colorado and Chief Portfolio Manager Anish Parvataneni of Illinois with commodity pool fraud and fraud in connection with options on futures contracts for false or misleading statements about worst-case losses, risk management, and LJM's risk profile.

The complaint charges LJM and Caine with failing to diligently supervise its employees and agents. According to the complaint, in January 2018 LJM had over $1 Billion in AUM, but on February 5 and 6, 2018, LJM's portfolios suffered large trading losses (over 80%) when the Chicago Board Options Exchange's Volatility Index ('VIX') spiked over 20 points and, shortly thereafter, LJM closed its business.

The CFTC complaint alleges that from at least June 2016 through February 2018, LJM managed several commodity pools, a mutual fund, and individually managed client accounts and made several false and misleading statements to prospective and existing pool participants and others in connection with its options trading strategies. The complaint alleges that LJM misrepresented the worst-case scenario for maximum daily losses of its strategies. The representations were false because the worst-case scenarios were not based on historical scenarios, and LJM's internal historical scenarios showed losses much greater than 40% for each strategy, according to the complaint.

The complaint further charges LJM with falsely representing to prospective and existing pool participants and others in connection with its options trading strategies that LJM had "robust risk management" that utilized historical scenario analysis when, in fact, LJM did not use historical scenarios in risk management. In addition, LJM failed to disclose in writing that it ignored the impact of volatility risk in risk management and that it failed to comply with its own internal risk policy. The complaint alleges that, by late 2017 through February 2018, LJM had significantly deviated from its historical risk profile and the portfolio's vulnerability to loss in certain scenarios more than doubled.

Caine is charged with liability for all of LJM's misrepresentations as a controlling person who knowingly induced the violations or did not act in good faith. Additionally, both Caine (registered AP of LJM) and LJM (registered CPO) are charged with failing to diligently supervise their employees and agents who, among other things, made certain false and misleading statements and failed to comply with LJM's risk policy.

CFTC orders Connecticut firm to pay $500,000 for wash sales

18 May 2021

The CFCT issued an order filing and settling charges against SummerHaven Investment Management LLC ('**SummerHaven**'), a Connecticut commodity trading advisor and commodity pool operator, for engaging in wash sales and non-competitive transactions and for failing to diligently supervise its activities.
According to the order, SummerHaven engaged in multiple wash sales and non-competitive transactions while moving positions from one futures commission merchant ('**FCM**') to another. Specifically, on July 2, 2018, SummerHaven placed offsetting buy and sell orders at each FCM, resulting in a series of offsetting trades in contracts for crude oil, heating oil, gasoil, live cattle, lean hogs, soybean meal, gasoline, cocoa, and cotton.

In total, SummerHaven placed more than 100 trades with a total of more than $570 million. The CFTC's order found that SummerHaven failed in its supervisory duties because it did not have policies or procedures in place to prohibit wash sales or non-competitive transactions, and because the decision

to execute such transactions was reviewed and directed by senior supervisory management, including SummerHaven's then-Chief Compliance Officer and then-Managing Partner.

The order requires SummerHaven to pay a civil monetary penalty of $500,000 and to cease and desist from further violations of the Commodity Exchange Act and CFTC regulations.

SEC charges fund manager and former race car team owner with multimillion dollar fraud

23 April 2021

The SEC charged Andrew T. Franzone, former owner of a race car team, and investment adviser FF Fund Management, LLC ('**FFM**') with fraudulently raising and misappropriating tens of millions of dollars from the sale of limited partnership interests in a private fund, FF Fund I LP.

The SEC's complaint alleges that Franzone defrauded investors by making misrepresentations regarding the fund's strategy and investments, failing to eliminate or disclose conflicts of interest, misappropriating fund assets, and falsely representing that the fund would be audited annually.

It is alleged that from August 2014 through September 24, 2019, Franzone told potential and existing investors that his investment strategy was to maintain a highly liquid portfolio primarily focused on options and preferred stock trading. Franzone allegedly raised more than $38 million for the fund from approximately 90 investors through these representations.

In reality, Franzone allegedly diverted substantial fund assets to an entity he owned and invested the fund's remaining assets mainly in highly illiquid private companies and real estate ventures. The complaint also alleges that Franzone's management of the fund was

subject to numerous conflicts that he did not eliminate or disclose, and that he misused fund assets. In addition, Franzone and FFM allegedly removed a critical safeguard for investors by failing to have the fund audited on an annual basis despite representations they would do so.

The SEC's complaint charges Franzone and FFM with violating the antifraud provisions of the federal securities laws and seeks disgorgement of ill-gotten gains, civil penalties, and permanent and conduct-based injunctive relief.

NFA orders former commodity trading advisor JDN Capital LLC never to reapply for NFA membership

19 April 2021

The NFA has ordered JDN Capital, LLC ('**JDN**'), a former NFA Member commodity trading advisor located in Stuart, Florida, never to reapply for membership or act as a principal of an NFA Member. NFA also ordered JDN's former sole principal and associated person Joshua David Nicholas not to reapply for membership for eight years and never to act as a principal of an NFA Member. If Nicholas seeks NFA membership following the eight-year period, he must pay a $125,000 fine.

The decision was based on a complaint issued by NFA's Business Conduct Committee and a settlement offer submitted by JDN and Nicholas, in which they neither admitted nor denied the allegations. The Hearing Panel found that Nicholas failed to cooperate promptly and fully with the NFA, failed to observe high standards of commercial honor and just and equitable principles of trade, and provided false and misleading information to the NFA during the investigation.

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Thank you for taking time to read our quarterly regulatory newsletter. If you have any feedback please share it with your consultant.

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