RQC Group Quarterly Regulatory Newsletter July 2020

Introduction

Welcome to our Q2, 2020 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 USA.

If 2020 is a Roland Emmerich 'disaster' movie, say Independence Day, January to March represented the part where the threat (aliens) is introduced and becomes tangible. Whereas in April to June, the humans fought back. We have not yet destroyed the mother ship but at least the main protagonists are on the case.

It's perhaps not often that financial services regulators are compared to Will Smith and Jeff Goldblum. But – over the last quarter - they too have had an opportunity to carefully appraise the impact of an existential threat. Covid-19 affects financial markets and financial institutions. It also affects people – those that have been financially disadvantaged, and those have had to significantly shift their working arrangements.

The underlying risks, which remain in a state of flux, determine where the regulatory priorities lie; both now and when we are able to return to normal, or perhaps the 'new normal'. Furthermore as we enter the second half of 2020, there will be an increased focus on other events that will impact the financial services industry: the end of the Brexit transitional period; and the US presidential election.

As well as exploring these themes, we present a variety of regulatory developments, news items and enforcement cases. Certain regulatory initiatives have been put in hiatus. However there remains much to discuss.

In addition, there has been a top brass change at the FCA. Nikhil Rathi, formerly UK head of the London Stock Exchange, becomes CEO, replacing the interim CEO Christopher Woolard who in turn replaced Andrew Bailey who left the FCA to become Governor of the Bank of England. We wish Mr. Rathi all the best in his new position.

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

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UK/EU - Ongoing Developments

Covid-19: Taking stock of regulatory priorities

As the Covid-19 landscape continually evolves, so do the challenges facing firms. Enactment of business continuity plans to enable large scale remote working is being replaced with how best to return to an office environment, to cite one example.

Similarly, regulatory priorities have also evolved. The mid-March slump affecting global equity indices and other asset classes prompted regulators to prioritise the orderly functioning of markets. Over 3 months' on from this, the UK Financial Conduct Authority ("**FCA**") believes that markets are now functioning in an orderly manner, a sentiment echoed by other national regulators who have, for instance, withdrawn various temporary short selling bans.

Since March, other regulatory themes have emerged. Presently, the FCA has a focus on prioritising the impact on consumers: keeping public access to essential banking services; protecting the most vulnerable in society; and supporting consumers with the immediate shocks created by the crisis. More thematically, the FCA is emphasising operational and financial resilience, and ensuring that firms act with integrity.

Regarding individual financial institutions, the FCA has sought to achieve a compromise between these regulatory priorities on one hand and allowing forbearance where firms might have difficulties in complying with certain requirements. This forbearance is not intended to encourage firms to conclude that their compliance risk profile is lower. Instead, it should act as a prompt for firms to re-calibrate this risk profile, and to apply this to areas where it is most needed.

Financial crime – another regulatory 'hot topic' – is a case in point. The FCA believes that whilst markets are now functioning in an orderly manner, market participants should not take their eye off the ball regarding market abuse risk – a point amplified in their recent Market Watch publication.

This publication highlights both an anticipated increase in primary market activity, as issuers of financial instruments seek additional capital, and potential disruption to firms' processes for dealing with inside information, due to home working.

Hence, the market abuse risk profile of many firms has changed; the FCA expects such firms to respond appropriately to this.

This can be contrasted with, for instance, the FCA initiative to increase the timeframe for providing audited financial statements to the regulator via GABRIEL, in response to issues in obtaining timely audit sign-off, and a similar initiative adopted by UK Companies House.

Regulators and financial institutions are tasked with formulating an appropriate regulatory response – the former via rule changes, guidance and other industry engagement, and the latter interpreting these in the most appropriate manner given their particular circumstances. This is not easy. We are in unchartered waters; the shocks to the financial system due to Covid-19 has very different characteristics compared to, for example, the aftermath of the 2008 financial crisis. A 'one size fits all' approach to such events would be wholly inappropriate.

This might be the time for industry participants to consider whether the regulatory ramifications of Covid-19 will be temporary – pending a continued winding down of the government imposed Covid-19 measures – or with longer term implications. This might in part depend upon two factors: (1) Whether there is a sustained economic downturn occurs in the aftermath of Covid-19; and (2) The extent to which society has to come up with a 'new normal' way of doing things, long after this particular virus has abated.

Compliance Survey

In June 2020, we asked investment firms to complete our inaugural UK compliance survey. Thank you to all that partook in this.

The survey results provide an insight into some of the key issues, concerns and priorities facing UK investment firms, concentrating on three topics:

- Compliance Present – the current regulatory environment
- Compliance Future – Brexit, Covid-19 and regulatory initiatives
- Internal compliance arrangements

Compliance Present

Cybersecurity risk is at the forefront of compliance minds. Almost 40% of respondents consider this to have the most significant impact on compliance arrangements due to Covid-19, and a similar number also see this as the key compliance risk that has emerged over the past 5 years.

One could glean from this that emerging cybersecurity risks have been magnified these past few months, due to the additional ways in which cybercriminals can wreak havoc. An increase in homeworking and usage of technology such as videoconferencing facilities create

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additional opportunities. Also, the number of cybercriminals has potentially increased, as miscreants find that they are unable to commit more 'traditional' crimes (it's harder to burgle a house if everyone is at home, for example).

Other compliance topics scoring highly include the increase in **regulatory reporting obligations** which sometimes appear to come at firms from many different angles – FCA GABRIEL returns, MiFID II transparency reporting, EMIR and SFTR disclosures and a whole host of others. **The Senior Managers and Certification Regime**, at present in its infancy for almost all investment firms, is another hot topic. In this regard, an FCA thought piece on conduct, culture and Covid-19 might be of interest.

On financial crime, one-third of respondents think that **market abuse** is their highest risk area, closely followed by **anti-money laundering** (almost 30%). This appears to mirror FCA concerns, with these two types of financial crime occupying the most column inches since the start of Covid-19. Bribery, fraud and tax evasion facilitation are the laggards

Compliance Future

Marketing funds in Europe remains a key consideration among the buy-side and – no doubt to many – a bugbear. Two in five respondents deem this to be the most important future regulatory initiative, whether due to Brexit or the upcoming legislative changes to the fund marketing framework, including the introduction of the concept of 'pre-marketing', which are scheduled to take effect in August 2021.

Marketing issues have not gone unrecognised. Last week the European Commission, in opining on the effectiveness of AIFMD, stated that '…the efficacy of the EU AIFM passport is impaired by national gold-plating, divergences in the national marketing rules, varying interpretations of the AIFMD by national supervisors and its limited scope.' Un-level playing fields due to the application of the national private placement regimes is also noted. It remains to be seen whether there will be any longer term legislative action to tackle these concerns.

Upcoming changes to the **regulatory capital framework for investment firms**, scheduled for June 2021, and ESG initiatives, are also prominent.

Speaking of **Brexit**, there are some bullish views regarding the state of play as at 1 January 2021. Almost 80% of respondents think that either the transitional period will be extended (despite the UK government vehemently denying that this will happen) or that the transitional period will be over, but that access to the EU marketplace will broadly remain unchanged.

In addition, almost 60% of respondents are, proactively or reactively, keeping a 'watching brief' on Brexit developments; as opposed to taking more pro-active strategic measures e.g. establishing a presence in the EU or recalibrating business activities away from the EU. As we near 31 December 2020, we may well see more pro-active courses of action.

On the topic of regulatory divergence after Brexit, there is a 50/50 split between the UK continuing to mirror the EU framework and the UK furrowing its own path. However, of the latter, a significant majority caveat that such divergence should be permitted only if the respective regimes continue to be 'equivalent'; the perception being that this would facilitate access to the EU by UK firms.

Regarding Covid-19, over 80% think that there will be some longer-term changes made to the regulatory framework as a consequence of the outbreak, but these will not be substantial.

Compliance Arrangements

We were delighted to learn that 80% of respondents consider their level of **compliance resource** to be just about right! Just under 40% of firms have a dedicated compliance officer, whilst at just under 30% of firms the compliance oversight role is performed by the Chief Operating Officer.

Finally, firms revealed that they use a variety of techniques to deliver **staff training**. The most popular choice was e-learning training (22%) followed by classroom training provided by an external provider (20%). Less popular choices include asking staff to read the compliance manual and other relevant documentation, or sending round emails remind staff of their compliance obligations. In our view, the best way of delivering the training is to employ a 'mix and match' approach i.e. supplement formal e-learning or classroom training with other, ad-hoc methods, whilst being mindful of the overall training and competency considerations for each staff member.

Post-Brexit UK regulatory environment: FCA and UK government paving the way

- **FCA Discussion Paper covers the future of the UK's prudential regime for investment firms**
- **UK Government sets out how the UK will address certain ongoing EU initiatives after 31 December 2020**

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Prudential regime for investment firms

The FCA has published a discussion paper (DP20/02) that sets out proposals regarding the new prudential regime for UK investment firms.

This will be based upon the EU's Investment Firm Directive ("**IFD**") and Investment Firm Regulation ("**IFR**"), which shall take effect - in the EU - from 26 June 2021. Click here to read our earlier article on this.

The UK has left the EU and therefore the IFD/IFR will not be implemented. However, the UK Government intends to create domestic legislation to introduce a UK equivalent regime.

The discussion paper sets out that this regime shall – broadly speaking – be based upon the IFD/IFR. However, there are instances where a national regulator has the discretion to interpret the legislation in a certain way, either because they have the discretion to do so or the text is ambiguous.

The paper details the FCA's interpretations and proposed approach regarding these discretionary aspects. It also asks stakeholders to provide responses to 35 questions, which cover aspects of the regime including:

- Defining of the fixed overheads requirement;
- How to calculate assets under management for the purposes of the K-factor, 'K-AUM' (plus determination of certain other K-factor calculations);
- Group consolidation;
- The new liquidity requirements;
- The updated 'Pillar 2' disclosure requirements (as an aside, the term 'ICAAP' which for many market participants is a well-established component of the vernacular vis-à-vis the prudential requirements, may be replaced with 'ICARA' – the Internal Capital Adequacy and Risk Assessment!);
- The updated remuneration framework; and
- The application of 'proportionality' for smaller investment firms.

The deadline for responding to the questions set out in the discussion paper is **25 September 2020**.

Future of UK regulation

In the foreword to the discussion paper Christopher Woolard, the (then) Interim Chief Executive of the FCA, acknowledges that the future of the UK/EU relationship will be determined by ongoing political negotiations. In addition, he asserts that the UK prudential regime should achieve similar intended outcomes to the IFD/IFR, but "taking into consideration the specifics of the UK market".

Elsewhere in the discussion paper, reference is made to the UK's involvement with, and influence over, the drafting of IFD/IFR, as the (erstwhile) member of the EU with the largest financial services sector.

As we have previously commented, the ability of UK investment firms to access the EU marketplace might depend upon the extent to which the UK regulatory framework aligns with that of the EU, within the framing of whatever can be agreed between the respective parties over the coming months.

Alongside prudential considerations, the UK government has provided detail on how it intends dealing with certain other EU initiatives after 31 December 2020. For example:

- The existing provisions of the EU's Securities Financing Transactions Regulation ('SFTR') shall apply, however the UK will not be taking action to incorporate into UK law the reporting obligation for non-financial counterparties ('NFCs'), which is due to apply in the EU from January 2021;
- Amending the Benchmarks Regulation to ensure continued market access to third country benchmarks until 2025;
- Amending the Market Abuse Regulation, for example, to confirm and clarify that both issuers and those acting on their behalf must maintain their own insider lists; and
- Improving the functioning of the packaged retail investment and insurance-based products ('PRIIPs') regime in the UK.

This perhaps sends a signal that the UK will – initially at least – continue to broadly replicate the EU regulatory framework, but with some exceptions.

The real test, however, might come when the EU starts to make substantive updates to existing legislation; thus prompting the UK to make a determination on the extent to which it wishes to become a 'rule taker'.

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UK/EU - Regulatory News

FCA SMCR deadline extension: Some relief, but still much to consider

30 June 2020

The FCA has extended the deadline for fulfilling certain elements of the Senior Managers and Certification Regime ("**SMCR**") from 9 December 2020 until 31 March 2021.

The FCA advises that it has made this change in order to give firms significantly affected by Coronavirus some additional time to fully implement SMCR.

This deadline extension applies to so-called 'Solo-regulated firms' – broadly speaking firms that are authorised and regulated by the FCA. SMCR took effect for Solo-regulated firms on 9 December 2019. Whilst substantive components of SMCR, including the Senior Managers Regime, took effect on this date, firms also have a transitional period to complete the following aspects of the regime:

- Provide training to employees subject to SMCR (aside from Senior Managers and Certified Staff) on the Conduct Rules, which take effect for relevant employees at the end of the transitional period. (Note that for Senior Managers and Certified Staff the Conduct Rules have in any event applied since 9 December 2019.);
- Assessing Certified Persons as fit and proper (i.e. conducting the initial certification; going forward this will be an at least annual requirement); and
- Providing information to the FCA on 'Directory Persons' (including Certified Persons and Non-executive Directors) so that they can be included on the newly launched Directory.

In-line with other regulatory extensions prompted by Coronavirus, the FCA notes that unaffected firms should seek to complete the requirements earlier than March 2021 if they are able to do so – the fit and proper certification for Certified Persons is cited in the FCA post. Many firms will seek to adopt this approach, on the premise that not conducting an early assessment a Certified Person – that turns out to be not fit and proper – carries regulatory and legal risk.

In addition, the FCA intends to publish details of Certified Persons on the Directory from 9 December 2020 i.e. this deadline remains unchanged. Noting that Certified Persons includes – for instance - portfolio managers, investment advisers and traders, firms that would like their publicly available Directory entry to be accurate from the offset have a further incentive to complete the outstanding processes affecting Certified Persons sooner rather than later.

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The FCA also notes that Senior Managers must ensure that Conduct Rules training is effective, and that they will be producing further communications about their expectations.

The adoption of SMCR for Solo-regulated firms comes at a challenging time for the UK financial services sector. SMCR is intended to be a game changer – improving culture, conduct and accountability at all levels within an organisation. The FCA has a webpage setting out its expectations in this regard.

In our view, firms should continue to ensure that their SMCR implementation planning remains robust, and that this reflects the changes to lines of communication and working habits that have characterised these past few months. Crucially, this includes ensuring that all relevant staff have a sound understanding of not only SMCR but also their other compliance related responsibilities and obligations.

FCA's expectations on the Approved Persons Regime and Coronavirus

30 June 2020

The FCA has set out their expectations to assist firms that are subject to the Approved Persons Regime.

This includes firms using Appointed Representative arrangements, since such firms are not currently subject to the Senior Managers and Certification Regime ("**SMCR**"), which has replaced the Approved Persons Regime for many financial institutions.

The advice is similar to that previously provided to firms subject to SMCR, and includes the temporary arrangements for controlled functions (extending the '12-week rule' to 36 weeks) and furloughing staff.

Principal firms (i.e. FCA regulated firms that are responsible for the activities of an Appointed Representative) are also reminded of their obligations in this regard.

UK Chancellor set out plans for LIBOR transition

23 June 2020

Rishi Sunak, the UK's Chancellor of the Exchequer, has set out initiatives regarding the transition away from LIBOR.

The Chancellor asserts that although the transition timetable has slowed due to Covid-19, it is nonetheless important for markets to continue to actively transition away from LIBOR, including ensuring that the number of open contracts referencing LIBOR is reduced as much as possible by the end of 2021.

The UK shall legislate to amend and strengthen the existing regulatory framework, in order to ensure that the FCA has the appropriate regulatory powers to manage and direct any wind-down period.

It is intended that these measures will form part of an upcoming Financial Services Bill.

FCA new data collection platform (RegData)

22 June 2020

The FCA has announced that it is preparing for a phased move of firms across to RegData, the new data collection platform that is set to replace its existing Gabriel platform with a faster and more accessible system.

Firms will be migrated to RegData in groups, with moving dates determined by reporting obligations and reporting schedules. Firms will be notified three weeks in advance of their accounts moving date. In advance the FCA is asking firms to ensure they have:

- Up-to-date contact details in Gabriel;
- Nominated the correct principal user and assigned administrator rights correctly in Gabriel; and
- Accurate information in Gabriel about all other active users.

See here for copies of the press release and webpage.

FCA reminds cryptoasset businesses to apply for registration

22 June 2020

The FCA has reminded businesses carrying out cryptoasset activities in the United Kingdom to complete an application for FCA registration by 30 June 2020. This will give the FCA time in order to have registration processed by 10 January 2021.

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Cryptoasset businesses operating before 10 January 2020 (when the FCA became the anti-money laundering and counter terrorist financing supervisor of businesses carrying out certain cryptoasset businesses) must be registered with the FCA by 10 January 2021 or cease trading. Cryptoasset businesses that began operating on or after 10 January 2020 must be registered with the FCA prior to commencing business.

See links here for the press release; the FCA's dedicated cryptoasset AML/CTF page; and further information about the registration process.

HM Treasury appoints new FCA Chief Executive

22 June 2020

On 22 June 2020, the FCA announced that HM Treasury has appointed Nikhil Rathi as the new permanent Chief Executive of the FCA.

Mr Rathi is currently the Chief Executive of London Stock Exchange plc. From September 2009 to April 2014, he was Director, Financial Services Group at HM Treasury. He is expected to take up the role in autumn 2020.

Mr Rathi will succeed Christopher Woolard, who has acted as interim Chief Executive since Andrew Bailey stepped down from the post in March 2020. Mr Rathi is being appointed for a five-year term.

Changes to EMIR Reporting Requirements

18 June 2020

On 18 June 2020, as part of the updating of the European Market Infrastructure Regulation (EMIR), known as 'EMIR Refit', various changes were made to the reporting obligation, and specifically the entities that are responsible for submitting the reports.

The reporting obligations require entities to disclose details of OTC and exchange traded derivatives to registered trade repositories.

At present, entities that are a party to a relevant transaction are responsible for submitting the report (even where this task is delegated to another entity). This includes funds (UCITS and AIFs).

Going forward, the UCITS management company shall be responsible for submitting the report

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where the UCITS is the counterparty and the AIFM of record shall be responsible for submitting the report where the AIF is the counterparty. This includes where the UCITS management company or AIFM has delegated the portfolio management function to another party (i.e. the other party does not have a reporting obligation).

In addition, entities that are categorised as 'NFC' (smaller non-financial counterparties), shall no longer be responsible for reporting where the other counterparty is a financial institution ('FC').

Although EMIR is EU legislation, the changes also apply to UK counterparties.

FCA updates webpage on reporting suspected market abuse

12 June 2020

The FCA has updated its webpage on how to report suspected market abuse as a firm or trading venue.

Previously, the webpage focussed on the submission of suspicious transaction and order reports ("STORs") which must be submitted where there is a reasonable suspicion of market abuse activity arising out of a transaction or an order conducted by a financial institution or a trading venue.

The updated webpage details how to notify the FCA of activity that has been observed in the market ('market observation') that may constitute market abuse but that does not fall under the STORs regime. For example, where a firm is not involved in the transactional activity and therefore does not have complete information.

This is intended to bolster the FCA's ability to monitor suspicious market activity.

European Commission publishes report assessing the application and scope of AIFMD

10 June 2020

The European Commission is required to review the application and scope of AIFMD, to assess the Directive's impact on stakeholders including investors, AIFs and AIFMs, both inside and external to the EU.

Their report, published in June 2020, makes a number of observations, including:

- As a result of AIFMD, AIFMs are now operating with greater transparency for investors and supervisors;
- The efficacy of the EU AIFM passport is impaired by national gold-plating, divergences in national marketing rules, varying interpretations of AIFMD by national supervisors and its limited scope;
- Similarly there are differences in the national private placement regimes of member states, and in addition an un-level playing field is created due to non-EU AIFMs marketing in the EU having to comply with a limited number of AIFMD requirements;
- Smaller AIFMs are sometimes unable to comply with marketing requirements and sometimes forego raising capital in EU member states;
- There has been an increase in the number of sales of AIFs, which aligns with increased investor protection, for example due to the depositary regime, rules on conflicts of interest and investor disclosure requirements;
- The lack of a depositary passport creates the issue of a limited choice of service providers which could lead to concentration risk vis-à-vis safekeeping of assets;
- The valuation rules are working well, albeit the presumption (when drafting AIFMD) that AIFMs will adopt either an internal valuer or an external valuer approach (but not a mixture of both) has caused some issues;
- Stakeholders have found measures related to financial stability, such as regulatory powers to impose leverage limits or suspend fund redemptions, to be useful. However further harmonisation between regulators is required; and
- Many stakeholders consider the leverage calculation methods (gross and commitment) to be appropriate. However there might b e some adjustments to this dependent upon the conclusion of work in this area carried out by the Financial Stability Board and IOSCO.

The report has been submitted to the European Council and the European Parliament. It might pave the way for legislative change in years to come e.g. 'AIFMD II'. As things currently stand, any future amendments would apply to the EU but not as a matter of course to the UK, not withstanding that the UK will adopt the existing AIFMD legislation into national law at the end of the Brexit transitional period.

ESMA sets out expectations on the MiFID II compliance function

5 June 2020

The European Securities and Markets Authority ("**ESMA**") has published its final guidelines on the compliance function at investment firms.

The guidelines are intended to enhance the value of existing standards by providing additional clarifications on certain specific topics. This includes concepts introduced by MiFID II, such as product governance.

The twelve guidelines are split into three sections:

- Responsibilities of the compliance function;
- Organisational requirements of the compliance function; and
- Competent authority review of the compliance function.

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They replace earlier guidelines that were published in 2012.

The guidelines are addressed to MiFID investment firms, credit institutions providing investment services, UCITS management companies and AIFMs.

ESMA updates various Q&As

29 May 2020

The European Securities and Markets Authority ("**ESMA**") has updated some of its Q&As, which are intended to provide guidance to market participants on certain regulatory topics.

1. MiFID2 and MiFIR transparency and market structure

The Q&A on market structures generally contains guidance on DEA and algorithmic trading, tick size regime including market making, multilateral and bilateral systems, and access to CCPs and trading venues.

It has now been updated under the heading of multilateral and bilateral systems, to include a guidance on authorisation of multilateral systems facilitating the execution of repurchase agreement (repo) transactions.

The transparency topics Q&A has seen a bit more updating, to include guidance on non-equity transparency, namely:

- Conversion of large in scale ("LIS")/size specific to the instrument ("SSTI") thresholds in lots [modification of a previous question];
- Default liquidity status, SSTI and LIS thresholds of non-equity instruments; and
- Publication of transaction in an aggregated form by APAs and trading venues

2. Investor protection under MiFID2/MiFIR

The updated Q&A includes a new answer on inducements under MiFID, specifically on the definition of minor non-monetary benefits and that the definition should be considered applicable to MiFID investment or ancillary services other than portfolio management and independent investment advice. Instead, the definition should be applied "[...] irrespective of the investment and ancillary service provided."

3. European Markets Infrastructure Regulation (EMIR).

The document has been updated to include Trade Repository Question 54, which contains clarification on the reporting of OTC derivative contracts by financial counterparties ("FC") on behalf of non-financial counterparties below the clearing threshold ("NFC-"), as per Art.9(1a) of EMIR, as amended by the EMIR refit.

More specifically, it contains clarifications for the financial counterparty on:

- Reportable details that should be provided by a NFC- to a FC;
- How a FC should proceed if the NFC- does not provide or renew its LEI;
- How a FC should proceed if a NFC that was classified as a NFC+ changes its status to NFC- and decides not to report itself, but fails to timely inform the FC of this; and
- How a FC and a NFC- should proceed if they report to two different trade repositories

4. Securitisation Regulation

The majority of the new questions and answers are designed to provide further clarification on the draft regulatory technical standards, more specifically on how to complete certain templates for disclosure included in the draft RTS.

FCA publishes Market Watch 63

27 May 2020

At the end of May 2020, the FCA published its Market Watch 63 newsletter, this time with a focus on market conduct and transaction reporting issues. The newsletter sets out their expectations on firms in lights of Covid-19 and the, for many firms, new working arrangements, in terms of:

- Control of inside information, including maintaining procedures, systems and controls around insider lists and market soundings;
- Appropriate disclosure of inside information by issuers to investors so that they are not misled;
- Personal account dealing controls to ensure against conflicts of interest as well as market abuse;
- Disclosure and transparency around short selling, including ensuring against 'naked' short selling; and
- Ensuring proper standards of market conduct in all participants on the financial markets during credit events and corporate finance events.

The FCA has set out before, on 6th May 2020, their expectations on firms' financial crime systems and controls, and the necessity to remain vigilant during these times. Market Watch 63 reinforces this message.

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The effects of the coronavirus have been significant for issuers globally, and this has led to issuers needing to raise capital, sometime substantial amount. The FCA is of the opinion that this potentially leads to an increase in inside information and to a change in what might constitute inside information for an issuer. The working from home arrangements that firms have been required to adopt could, in the FCA's view, raise risks in terms of identifying and handling inside information.

Therefore, market participants should continue to assess their procedures, systems and controls they have in place, and that these remain adequate.

Issuers

Issuers should assess what constitutes inside information under the coronavirus, and monitor any new information from this perspective.

The use of insider lists is also mentioned, and issuers are encouraged to consider how staff in receipt of inside information will be made aware of their legal and regulatory duties as well as their being placed on an insider list.

Issuers are also reminded of their obligations under the Market Abuse Regulation ("**MAR**") to disclose inside information that directly concerns them as soon as possible, subject to certain rules on delayed disclosure.

All market participants

The Market Watch newsletter sets out the inside information obligations under MAR, including some suggestions for firms such as "reviewing the availability [...] of controls for restricting access to inside information [...] or even taking this opportunity to repeat or refresh staff training on how to handle inside information."

All natural persons are subject to the prohibitions on unlawful disclosure and insider dealing. The FCA reminds firms that, information may become inside information when coupled with other

information held by a natural person. Firms should have procedures, systems and controls in place to comply with their obligations under MAR, including unlawful disclosure and insider dealing. Procedures would include restriction to access to inside information to those who need it to fulfil their role, and firms should review, control and monitor who has access to inside information.

Any persons handling inside information should ensure that it is only disclosed where disclosure is necessary in the normal exercise of employment, a profession, or duties.

Market soundings under MAR is also noted as a specific framework for wall crossings, and one that is useful to issuers to gauge interest of market participants, as long as there are control mechanisms for handling the information. Both participants should maintain their own records of what was said.

Personal account dealing is another area, also discussed in Market Watch 62 that the FCA considers as a heightened risk when staff is working from home. Firms should assess how they can mitigate any risk of conflicts of interest, as well as of market abuse.

Short selling

The FCA as a regulator generally recognises that short selling can be an important market mechanism. However, in this newsletter, firms are reminded to ensure that they are able to continue to fulfil their obligations regarding disclosures of short sales. The transparency that this provide is stated as an important functioning of the markets.

- Borrowed the share;
- Entered into an agreement to borrow the share; or
- Have an arrangement with a third party who confirms that the share has been located.

Any such arrangement must work in practice, and must work during the new working arrangements.

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The FCA also reminds firms of the net short position reporting threshold. This is set to 0.1% of the issue of share capital, following the decision by ESMA on 16 March to temporarily lower the minimum threshold.

Firms are also reminded that any net short position of 0.5% or over must be reported to the FCA, which will publish these positions on a daily basis on their website.

The FCA will continue to monitor short selling activities and may contact firms to understand the nature, purpose, and construction of their net positions as reported to the FCA. Should the FCA have concerns of significant opportunities for abusive behaviour, they may increase their monitoring activity. The regulator states that:

- If we have concerns that abusive trading is occurring, we will use our enforcement powers to take action. We could also use our short selling powers to restrict or prohibit short selling activity for specific shares or other financial instruments, which we will consider if we have evidence suggesting it is necessary.

Market Surveillance

Firms generally should undertake risk assessments to understand the market abuse risks that they are subject to, and specifically during the coronavirus pandemic, firms should review their risk assessments in light of the current situation and the new working from home arrangements. This could include modifying surveillance systems, to ensure these remain adequate. Risks, as above, could involve inside information and misuse thereof, or abusive behaviours. Surveillance tools should be calibrated to ensure these include new and emerging risks.

The FCA concludes the Market Watch newsletter by stating that they will continue to monitor the markets, making use of all of the tools they have to do so: transaction reporting, order book reporting, inside information disclosures, price movement monitoring and reporting on net short positions. They will continue to use their powers to request information and make enquiries where they have identified abusive or suspicious behaviour.

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UK/EU - Enforcement

FCA fines Commerzbank London £37,805,400 over anti-money laundering failures

17 June 2020

Commerzbank AG, London Branch ("**Commerzbank London**") has been fined £37,805,400 for failing to implement effective anti-money laundering and risk management systems, despite the FCA raising specific clear warnings about weaknesses in the preceding years.

Over the course of October 2012 to September 2017, it was found that Commerzbank London had failed to address shortcomings in its financial crime controls, thus breaching Principle 3. Failings included:

- Inadequate due diligence checks, such as the consideration of risks posed by politically exposed persons;
- A lack of consistency between business areas in the verification of beneficial ownership;
- A significant backlog of existing clients awaiting periodic KYC review and allowing such clients to continue undertaking transactions despite some being considered high-risk;
- A lack of clarity around responsibilities held by risk owners within the business.

As a consequence of these inadequacies in its AML control framework, Commerzbank London was unable to adequately identify, assess, monitor or manage its money laundering risk. The Firm created a significant risk that financial and other crime might be undetected, thus challenging the integrity of the UK financial system.

This follows a number of other high-profile AML related FCA sanctions against banks, including Barclays, Deutsche Bank and Standard Chartered Bank, in recent years.

FCA bars four Cypriot firms that used unauthorised celebrity endorsements

01 June 2020

Four Cypriot firms that used unauthorised celebrity endorsements on social media as part of their marketing have been barred by the FCA by having their passporting rights removed. It is the first time the FCA has used its powers to remove passporting rights of firms.

The orders require the four firms to stop selling contracts for difference ("**CFDs**") to UK customers, to close existing positions with UK customers, to return UK customers' money and to notify UK customers of the FCA's action.

The four firms below used the fake celebrity endorsements and other tactics to persuade UK customers to trade CFDs:

- Hoch Capital Ltd (trading as iTrader and tradeATF);
- Magnum FX (Cyprus) Ltd (trading as ET Finance);
- Rodeler Ltd (trading as 24option); and
- F1Markets Ltd (trading as Investous, StrattonMarkets and Europrime).

The firms also charged undisclosed fees to customers and failed to inform them of the risks of trading CFDs.

The FCA estimates that UK investors have lost hundreds of thousands of pounds in these investments.

FCA Final Notice 2020: Paul Milsom – Insider Dealing

27 April 2020

On 27 April 2020, the FCA released a final notice prohibiting Mr. Milsom from performing any function in relation to any regulated

activity carried on by any authorised person, exempt person or exempt professional firm.

Mr. Milsom committed offences involving dishonesty. In particular, he:

- Pleaded guilty on 16 January 2013, at the City of Westminster Magistrates Court, to Insider Dealing, contrary to Section 52(2)(b) of the Criminal Justice Act 1993;
- Also admitted a further offence to be taken into consideration, namely Insider Dealing, contrary to Section 52(2)(b) of the Criminal Justice Act 1993; and
- Was sentenced on 7 March 2013, at Southwark Crown Court, to 2 years imprisonment and ordered to pay £245,657.58 under section 6 of the Proceeds of Crime Act 2002.

At the time of committing the insider dealing offences, Mr. Milsom was an approved person at an FCA regulated firm, Legal and General Investment Management Ltd, where he worked as an equities dealer.

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USA - Ongoing Developments

Introduction

While we'd all happily welcome in a period of relative market calm and a return to some form of normalcy, it is an election year in America and those typically bring with them an abundance of market volatility. Throw in the recent nomination of current SEC chairman Jay Clayton to be the next United States attorney for the Southern District of New York, and it would appear (continuing a theme from the pre-amble to this newsletter) we're still a way away before Will Smith's character can knock an alien out and emphatically pronounce "Welcome to Earth!"

Thus far throughout the period of lockdown, the SEC's examination staff have remained active, and exams and enforcements are still taking place. The Office of Compliance Inspections and Examinations put out a Risk Alert discussing commonly encountered observations from examinations of investment advisers which we dive into below.

Observations from examinations of investment advisers managing private funds

In June 2020, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") released a Risk Alert providing an overview of certain compliance issues observed in examinations of registered investment advisers ("**Advisers**") that manage private equity funds or hedge funds.

The deficiencies identified focussed on 1) conflicts of interest, 2) fees and expenses, and 3) policies and procedures relating to material non-public information ("**MNPI**"), all of which may have caused investors to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest.

1. Conflicts of Interest

- **Conflicts related to allocations of investments**

  The staff observed Advisers that did not provide sufficient disclosure about conflicts relating to allocations of investments among clients e.g. Advisers preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts without sufficient disclosure.
  The staff also observed securities being allocated at different prices or in apparently inequitable amounts among clients without adequate disclosure, or in a manner inconsistent with allocation policies disclosed to clients.

- **Conflicts related to multiple clients investing in the same portfolio company**

  The staff observed Advisers that did not provide sufficient disclosure about conflicts created by having clients invest at different levels of a capital structure e.g. one client owning debt and another client owning equity in a single portfolio company, thereby depriving investors of important information related to conflicts associated with their investments.

- **Conflicts related to financial relationships between investors or clients and the Adviser**

  The staff observed Advisers that did not provide adequate disclosure about economic relationships between themselves and select investors or clients e.g. seed investors into a private fund, or private fund investors with an economic interest in the Adviser.

- **Conflicts related to preferential liquidity rights**

  The staff observed Advisers entering into side letters that established special terms, including preferential liquidity terms, but did not provide adequate disclosure about these side letters. Similarly, the staff observed Advisers that set up undisclosed side-by-side vehicles that invested alongside the flagship fund, but had preferential liquidity terms.
  Other investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms granted by their side letters, or if the selected investors redeemed their investments ahead of other investors, particularly in times of market dislocation where there is a greater likelihood of a financial impact.

- **Conflicts related to Adviser interests in recommended investments**

  The staff observed Advisers with interests in investments recommended to clients, but did not provide sufficient disclosure of such conflicts e.g. referral fees or stock options on the investments.

- **Conflicts related to co-investments**

  The staff observed inadequately disclosed conflicts related to investments made by coinvestment vehicles, potentially

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misleading certain investors as to the existence of such coinvestment opportunities, how these coinvestments operate, the scale of coinvestments and in what manner coinvestment opportunities would be allocated among investors.

The staff also observed Advisers that disclosed a process for allocating coinvestment opportunities but failed to follow the disclosed process.

- **Conflicts related to service providers**

  The staff observed inadequately disclosed conflicts related to service providers and Advisers e.g. portfolio companies controlled by Advisers' private fund clients entered into service agreements with entities directly or indirectly controlled by the Adviser. The staff also observed Advisers with other financial incentives for portfolio companies to use certain service providers, but failure to adequately disclose the incentives and conflicts to investors.

- **Conflicts related to fund restructurings**

  The staff observed private fund advisers that inadequately disclosed conflicts related to fund restructurings e.g. Advisers purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the conflict to investors or the value of the interests, potentially impacting the decisions made by the investors.

- **Conflicts related to cross-transactions**

  The staff observed Advisers that inadequately disclosed conflicts related to purchases and sales between clients, or cross transactions e.g. Advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged either the selling or purchasing client but without providing adequate disclosure to its clients.

1. Fees and Expenses

OCIE staff observed the following fee and expense issues that appear to be deficiencies under Section 206 or Rule 206(4)-8 of the Advisers Act:

- **Allocation of fees and expenses**

  The staff observed Advisers that inaccurately allocated fees and expenses e.g. allocating shared expenses among the Adviser and its clients in a manner that was inconsistent with disclosures to investors, charging private fund clients for expenses not permitted by the relevant operating agreement, failure to comply with contractual limits on certain expenses and failure to follow their own travel and entertainment expense policies.

- **"Operating partners"**

  The staff observed Advisers that did not provide adequate disclosure regarding the role and compensation of individuals that may provide services to the private fund or portfolio companies, but are not adviser employees (known as "operating partners"), potentially misleading investors about who would bear the costs associated with these operating partners' services and potentially causing investors to overpay expenses.

- **Valuation**

  The staff observed Advisers that did not value client assets in accordance with their valuation processes or in accordance with disclosures to clients. In some cases, the staff observed that this failure to follow the disclosed valuation process led to overcharging management fees and carried interest because such fees were based on inappropriately overvalued holdings..

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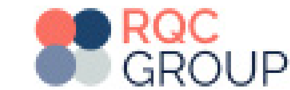

- **Monitoring / board / deal fees and fee offsets**

  The staff observed Advisers with issues with respect to the receipt of fees from portfolio companies, such as monitoring fees, board fees, or deal fees e.g. failure to apply or calculate management fee offsets in accordance with disclosures and therefore causing investors to overpay management fees, or Advisers who disclosed management fee offsets, but did not have adequate policies and procedures to track the receipt of such fee offsets.

3. MNPI / Code of Ethics

Section 204A of the Advisers Act requires Advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the Adviser or any of its associated persons. Advisers Act Rule 204A-1 ("**Code of Ethics Rule**") requires Advisers to adopt and maintain a code of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.
OCIE staff observed the following issues that appear to be deficiencies under Section 204A and the Code of Ethics Rule:

- Advisers did not address risks posed by their employees interacting with insiders of publicly-traded companies, outside consultants arranged by "expert network" firms, or "value added investors" in order to assess whether MNPI could have been exchanged;
- Advisers did not address risks posed by their employees who could obtain MNPI through their ability to access office space or systems of the Adviser or its affiliates that possessed MNPI;
- Advisers did not address risks posed by their employees who periodically had access to MNPI about issuers of public securities;
- Advisers did not enforce trading restrictions on securities that had been placed on the Adviser's "restricted list", or did not have defined policies and procedures for adding securities to, or removing securities from, such lists;
- Advisers that failed to enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties; and
- Advisers that failed to require access persons to submit transactions and holdings reports timely or to submit certain personal securities transactions for preclearance as required by their policies or the Code of Ethics Rule, as applicable.

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USA - Regulatory News

CFTC adopts Bad Actor Disqualifications for CPO exemptions

04 June 2020

CFTC adopts Bad Actor Disqualifications for CPO exemptions

The Commodity Futures Trading Commission ("**CFTC**") unanimously approved a final rule prohibiting persons from seeking to claim a Commodity Pool Operator ("**CPO**") registration exemption who have, or whose principals have, incurred any of the relevant statutory disqualifications listed in the Commodity Exchange Act ("**CEA**").

The amendment to Regulation 4.13 generally prohibits persons who have, or whose principals have, in their backgrounds any of the statutory disqualifications listed in section 8a(2) of the CEA from seeking to claim a CPO registration exemption under Regulation 4.13.

Specifically, the final rule will require any person filing a notice claiming such exemption to represent that, subject to limited exceptions, neither the claimant nor any of its principals has in their background a CEA disqualification that would require disclosure, if the claimant sought registration with the CFTC.

The final rule is effective 60 days after publication in the Federal Register.

CFTC proposes changes to Form CPO-PQR

14 April 2020

The CFTC has published a proposal to amend certain compliance requirements for commodity pool operators under CFTC Rule 4.27 and CFTC Form CPO-PQR, as codified at Appendix A to the CFTC's Part 4 rules.

The proposal is first substantive amendment to CFTC Form CPO-PQR since it was adopted in 2012.

The proposal eliminates certain pool-specific reporting requirements and questions regarding a pool's auditors and marketers; and amends the information in existing Schedule A of the form to request Legal Entity Identifiers (LEIs) for CPOs and their commodity pools. These amendments, if adopted, will focus Form CPO-PQR on data elements that facilitate the Commission's oversight of CPOs and their pools while reducing overall data collection requirements for CPOs in favour of relying on data from other existing sources.

The CFTC requests comments on the proposed rule and makes specific requests for comments in the notice of proposed rulemaking. Comments are due to the CFTC by June 15, 2020.

that, subject to limited exceptions, neither the claimant nor any of its principals has in their background a CEA disqualification that would require disclosure, if the claimant sought registration with the CFTC.

The final rule is effective 60 days after publication in the Federal Register.

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USA - Enforcement

Private equity firm Ares Management LLC charged with compliance failures

26 May 2020

The US Securities and Exchange Commission ("**SEC**") announced that Ares Management LLC, a Los Angeles-based private equity firm and registered investment adviser, agreed to pay $1,000,000 to settle charges that it failed to implement and enforce policies and procedures reasonably designed to prevent the misuse of material non-public information ("**MNPI**").

The SEC's order finds that, in 2016, Ares invested several hundred million dollars in a public company which allowed Ares to appoint a senior employee to the portfolio company's board of directors. The order finds that Ares's compliance policies failed to account for the special circumstances presented by having an employee serve on a portfolio company's board while that employee continued to participate in trading decisions regarding that same portfolio company.

According to the order, Ares subsequently obtained potential MNPI about the portfolio company relating to changes in senior management, adjustments to the company's hedging strategy, and decisions with respect to the portfolio company's assets, debt, and interest payments. After receiving this information, Ares purchased more than one million shares of the company's common stock, which amounted to approximately 17% of the publicly available shares at the time.

The order finds that Ares did not require its compliance staff, prior to approving the trades, to sufficiently inquire and document whether the board representative and members of his Ares team possessed MNPI relating to the portfolio company.

The order also finds that Ares violated the compliance policies and procedures requirements of Sections 204A and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder.

Without admitting or denying the findings, Ares consented to the entry of a cease-and-desist order and a censure, and to pay a civil penalty of one million dollar

SEC charges California trader engaged in manipulative trading scheme involving COVID-19 claims

09 June 2020

The SEC has charged a penny stock trader, Jason C. Nielsen, conducting a fraudulent pump-and-dump scheme in the stock of a biotech company, Arrayit Corporation.

Mr. Nielsen tried to drive up the company stock price through posting misleading statements in an online investment forum about the false assertion that the company had developed an "approved" COVID-19 blood test.

In addition, Mr. Nielsen also allegedly created the false impression of high demand for Arrayit Corporation stock by placing and subsequently canceling several large orders to purchase shares. The SEC temporarily suspended trading in Arrayit Corporation securities on 13 April 2020 to avoid further profit being made.

SEC awards record payout of nearly £50 million to Whistleblower

04 June 2020

The SEC has awarded the largest amount on record to one individual under its Whistleblower Program. The first-hand, detailed account provided by the individual led to a successful enforcement action that returned a significant amount of money to harmed investors.

The SEC has awarded over $500 million to 83 individuals since issuing its first award in 2012.

SEC obtains receiver over Florida investment adviser charged with fraud

13 May 2020

The SEC announced that it has obtained the appointment of a receiver over Florida-based investment adviser TCA Fund Management Group Corp., its affiliate TCA Global Credit Fund GP Ltd. (TCA-GP), and several funds managed by TCA to protect investors from a fraudulent scheme allegedly conducted by TCA.

The SEC's complaint alleges that TCA improperly recognized revenue in order to fraudulently inflate net asset values and performance for several funds it managed, resulting in the funds always reporting positive returns. TCA allegedly distributed promotional materials to current and prospective investors that included the inflated asset values and false performance results. TCA and TCA-GP also allegedly distributed monthly account statements to investors falsely representing monthly returns and investment balances based on the inflated asset values. The complaint further alleges that the funds paid inflated management fees to TCA and inflated performance fees to TCA-GP.

The complaint charges TCA and TCA-GP with violating the antifraud provisions of the federal securities laws, and seeks permanent injunctions, disgorgement of allegedly ill-gotten gains with prejudgment interest, and financial penalties.

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

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