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PRIVATE BANK BRIEFING

LATHAM & WATKINS

Issues Impacting the Private Bank Sector

Welcome to our quarterly round-up of legal and compliance issues impacting private banks and their clients.

In This Edition

FCA Business Plan 2018/19

The FCA's Business Plan for 2018/19, published on 9 April 2018, outlined key priorities for the upcoming year. Although the Business Plan revealed that the FCA's Brexit-related workload will mean a dearth of new initiatives, the document did reveal a number of interesting initiatives that the FCA has chosen to pursue. Given the FCA's limited resources, only the highest-priority items are likely to have qualified, and so should be viewed in that context.

Some of the key initiatives relevant to private banks are highlighted below:

Topic	Initiative
FinTech	The FCA will work with the Bank of England and HM Treasury to develop thinking around cryptocurrencies, and will publish a Discussion Paper later in 2018 outlining its policy thinking.
MiFID II	FCA supervisory priority areas will include research unbundling, best execution, and payment for order flow, as well as algorithmic trading.
Markets	The FCA will publish an "Approach to Market Integrity" document this year, outlining the FCA's expectations regarding conduct in wholesale markets.
TCF	The FCA will bring forward planned work to consider whether to introduce a duty of care provision for firms. The FCA intends to publish an initial Discussion Paper in summer 2018.
Remuneration	The FCA will be looking at firms' remuneration arrangements. While the focus will be on firms that are not subject to any of the Remuneration Codes, we expect there to be read-across for other firms.
Individuals	The FCA plans to publish a consultation in summer 2018 on policy proposals to introduce a public register for individuals falling within the Certification Regime under the SMCR.
Investments	This year, the FCA plans to publish research looking at the rise of passive management and the impact on core aspects of financial market performance.
Cybersecurity	The FCA plans to strengthen its supervisory assessments of the highest impact firms, to better understand firms' use of technology, resilience to cyber-attacks, and staff expertise. The FCA will conduct thematic work in relation to lower-impact firms.
Outsourcing	The FCA will focus on outsourcing arrangements, in particular on arrangements in which many firms rely on a single service provider. This will involve several pieces of thematic and firm-specific work.
Payments	The FCA is working to develop a payments sector strategy, and wants to improve its understanding of key players, and of current and emerging trends, in the sector.

Product Intervention: Scope of Binary Options Ban

The European Securities and Markets Authority (ESMA) formally adopted its first temporary product intervention measures under MiFID II on 22 May 2018, and the final measures were published on 1 June. The measures will introduce:

- A prohibition on the marketing, distribution, or sale of binary options to retail investors in the EU, from 2 July 2018
- A restriction on the marketing, distribution, or sale of contracts for differences (CFDs) to retail investors in the EU, from 1 August 2018

While most private banks will steer clear of offering CFDs and binary options to customers, many will offer structured products. However, given the potential scope of the ban on binary options, some structured products may be caught.

The final measures relating to binary options apply to derivatives:

- That must or may be settled in cash
- That only provide for payment at close-out or expiry
- In relation to which payment is limited to a predetermined fixed amount or zero, if the underlying meets (or does not meet) one or more predetermined conditions

Although this definition is reasonably narrow, commentary in the preamble suggests that the ban may be wider than this in scope.

Private banks should ensure that the suite of products they offer, including structured products, do not fall foul of the ban. In doing so, they should consider factors such as the maturity of the product, the distribution mechanics, and the investment purpose.

As ESMA's product intervention powers are temporary, and only enable ESMA to introduce measures lasting a maximum of three months, ESMA will need to renew the measures periodically for them to stay in force.

> In the UK, the FCA has already indicated that it expects to consult on applying these measures on a permanent basis.

Unfair Terms: FCA Consults on New Guidance on Variation Terms

The FCA published a Guidance Consultation on the fairness of variation terms in financial services consumer contracts on 17 May 2018.

The FCA is publishing proposed new guidance following the introduction of the Consumer Rights Act 2015 (the CRA), and in light of a number of rulings on variation terms at EU level. The FCA previously removed various materials on unfair contract terms from its website, so this new FCA guidance will be helpful for firms. The guidance will apply to all financial services consumer contracts entered into after 1 July 1995.

The draft guidance focuses in particular on unilateral variation terms; the FCA acknowledges that these are some of the most complex terms to assess in terms of fairness. The FCA is keen to stress that unilateral variation terms can be fair, and can be beneficial to consumers (for example, by allowing firms to vary interest rates to the benefit of the consumer), but only if they are drafted fairly. The guidance is therefore intended to assist firms by setting out a non-exhaustive list of factors the FCA considers relevant to an assessment of fairness.

As well as outlining detailed guidance, the FCA lists some overarching points that firms should bear in mind:

- A variation term cannot benefit from the "core" exemption under the CRA, and therefore always can be assessed for fairness
- If a variation term falls within a qualification to the "grey list", it does not automatically render the term fair
- Fair treatment of customers when making a change to the contract does not alter the fact that a variation term is unfair

Notably, the proposed guidance also explicitly references the SMCR, indicating that the FCA expects firms to allocate responsibility for ensuring that consumer contracts are fair and transparent under unfair terms law to an appropriate individual. This is not an official "Prescribed Responsibility" under the SMCR, and represents another example of the FCA adding to its expectations under the regime on an ongoing basis.

Comments are due on the consultation by 7 September 2018. Once finalised, the guidance will complement material already in the unfair contract terms library on the FCA website.

> The FCA indicates on its website that it does not plan to conduct a proactive systemic review of variation terms in contracts entered into prior to the final guidance being issued. This suggests that the FCA will not necessarily expect firms to go back and review existing contracts, although the guidance states that it should be taken into account when reviewing existing contracts.

PRIIPs: Industry Continues to Lobby for Review

Lobbying efforts continue to try to persuade the European Commission to revisit the methodologies underlying calculations for PRIIPs KIDs.

French and German industry associations AMAFI and the DDV recently wrote to the European Commission to explain their concerns about the quality of information being provided to investors. The associations also urged the Commission to revise the Regulatory Technical Standards setting out the calculation methodologies for the PRIIPs KID.

Both associations relay industry-wide concerns that the information produced by following the prescribed calculations often results in confusion.

The associations explain that their members have received negative reactions to their KIDs, and often have to supplement the KID with additional information to ensure that investors are adequately informed about the product. Particular concerns arise in relation to information in the KID regarding performance scenarios and costs, and the letter provides some illustrative examples of unclear results.

In January 2018, the UK regulator highlighted the same concerns, and the potential necessity of providing extra information to investors to ensure that communications are accurate, fair, clear, and not misleading. The FCA has voiced its concerns about the often unfortunate consequences of the PRIIPs Regulation on other occasions too.

> *"Both associations relay industry-wide concerns that the information produced by following the prescribed calculations often results in confusion".*

Most recently, Andrew Bailey mentioned at the FCA's Asset Management Conference that the regulator will be issuing a call for input from the industry in July, to explore the scale of the issues arising from the PRIIPs framework. It will be interesting to see what the FCA proposes to address these issues, particularly in the context of Brexit.

AMAFI and the DDV stress in their letter that further Q&A on the interpretation of the PRIIPs Regulation will not suffice; they are pushing for the legislation to be amended. The Commission is due to review the PRIIPs Regulation by the end of the year in any event, but it will be interesting to see whether the continuing lobbying efforts result in swifter action.

Sanctions: US Designation of Further Russian Individuals and Entities

The US Treasury Department's Office of Foreign Assets Control (OFAC) added a number of new individuals and entities from Russia to its list of Specially Designated Nationals (SDN List) on 6 April 2018. Notably, these designations also impact a number of parties with substantial assets and business ties outside of Russia. Particular caution is needed, as several of the newly designated SDNs are chief executives of or other leading figures associated with major Russian companies, though the companies themselves have not been designated. Although dealing with these companies is not prohibited, care must be taken to ensure that any dealings with the companies in situations in which there is a US jurisdictional nexus do not result in the provision of funds, goods, or services to or from an SDN.

> *"US sanctions are constantly evolving, notoriously broad in scope, and have extraterritorial effect".*

US sanctions prohibit US persons from engaging in most transactions or dealings (including the provision or receipt of goods or services) not only with parties on the SDN List, but also with entities that are 50% or more owned by one or more SDNs. In addition, the property and property interests of an SDN that are in the US or within the possession or control of a US person must be blocked and reported to OFAC within 10 business days. For these purposes "US persons" includes US entities, including their overseas branches, as well as US nationals and US lawful permanent residents, and anyone present in the US.

Non-US persons can also be impacted by so-called US "secondary" sanctions if they facilitate a "significant transaction", including deceptive or structured transactions, for or on behalf of an individual or entity subject to Russia-related sanctions, or for the child, spouse, parent, or sibling of a sanctioned individual. Separately, non-US financial institutions are subject to US secondary sanctions, which means that they may face penalties for knowingly facilitating "significant financial transactions" on behalf of an SDN subject to Russia-related sanctions.

Private banks should assess the impact of these new designations on their business. Due to the far-reaching nature of US sanctions, all financial institutions must be aware of these measures, regardless of their global footprint.

US sanctions are constantly evolving, notoriously broad in scope, and have extraterritorial effect. Private banks should ensure that they monitor new licenses, policies, and designations from OFAC on an ongoing basis to ensure that they keep up to date with developments.

Advice: FCA Review of Robo-Advisers Finds Areas for Improvement

The FCA published a webpage with findings from its review of automated investment services on 21 May 2018. The FCA conducted two reviews — the first looked at seven firms offering automated online discretionary investment management (ODIM) services, and the second looked at three firms providing retail investment advice exclusively through automated channels (auto advice). The FCA explains that, at the time of the review, these firms were the early entrants to this developing market.

Although the review focused on new entrants, the FCA does note some important points for existing firms that are considering offering these services, such as private banks, to bear in mind. The FCA highlights that its rules apply regardless of the medium through which the service is offered. Moreover, the FCA expects both existing firms and new entrants to consider the issues outlined in the review, and to take action if needed. The FCA also encourages firms to consider FG17/8: streamlined advice and related consolidated guidance. This publication sets out the FCA's expectations regarding streamlined advice and fact-find processes.

Particular points to note from the review include:

- **Suitability:** The FCA stresses that automated investment services firms must undertake a suitability assessment to confirm that a personal recommendation or a decision to trade is suitable for each client. The FCA expects automated investment services to meet the same regulatory standards as traditional discretionary or advisory services. Therefore, firms should ensure they conduct a proper suitability assessment, and should not assume that their service is suitable for all clients.
- **Governance:** The FCA found little consideration of auto advice-specific risks in firms' governance processes. Firms need to consider whether adequate testing of the offering has been conducted, and to clarify the action that should be taken if unsuitable recommendations are identified. Firms also need to be clear about the nature of the service being provided, and who holds responsibility.
- **Vulnerable customers:** Firms need to be equally robust in identifying and supporting vulnerable consumers as they would with traditional services, and should not rely on a client to self-identify as vulnerable.
- **Filtering:** Firms that rely on filtering tools as part of their automated processes should have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results.

The FCA has indicated that it will carry out further reviews later this year. These reviews will include an assessment of how firms are complying with the new requirements introduced by MiFID II, and whether the cumulative effect of MiFID II and PRIIPS is helping achieve the intended outcome.

Conduct Risk: 5 Questions from the FCA

The FCA remains focused on conduct risk, yet many firms struggle to pinpoint what an appropriate conduct risk framework might look like in practice. Conduct and culture are often inextricably linked, yet both can be seen as rather nebulous concepts, and therefore can be equally difficult to define and manage.

The FCA has offered reasonably little guidance to date, but its "5 Conduct Questions" programme does provide some useful steers for firms as to what the regulator expects in terms of tackling conduct risk. Although carried out in the wholesale banking sector, the guidance is relevant both to other areas of banking, and to the financial services sector more broadly.

The FCA has published two feedback reports from its programme so far — the most recent one in April 2018 — and both reports contain some noteworthy commentary. In particular, the FCA has observed that:

- Nearly all front-line businesses surveyed have taken full ownership for conduct risk and related change and development programmes.
- Some firms have created new First Line of Defence (front office) roles with titles such as "Chief Conduct Officer" or "Head of Conduct and Culture", with a mandate to develop a holistic approach to the firm's conduct programmes.
- Firms have also created or enhanced front office supervision tools to improve the ability of business heads to monitor and manage directly.
- More firms have expanded their programmes to include full front-to-back or end-to-end risk reviews, rather than limit their focus on more immediate client-facing activity.
- Firms increasingly base performance, promotion, and remuneration on separate assessments of "how" individuals perform in addition to "what" they achieve. Firms then integrate the two assessments for a more complete individual profile.

Despite the progress made, the FCA also emphasises that firms should be aware that conduct risk may arise across the whole organisation and not just in the front-line business areas.

Another area for improvement is that many firms initially focused only on meeting regulations and their own policies and procedures. Firms must now shift more of their attention externally to consider whether their actions are causing, or have the potential to cause, harm to customers or markets.

The feedback reports also highlight what constitutes an effective conduct risk programme. Unsurprisingly, this includes factors such as:

- Highly visible CEO sponsorship, together with engagement and challenge from the Board
- Senior executives taking leading roles in programme design
- Programmes that cover front office, control, and operational functions
- Use of a standardised conduct risk self-assessment process across the firm
- Regular discussion at Board level of conduct, culture, and programme implementation
- Active engagement in the programme by internal audit
- Long-term conduct risk initiatives becoming fully embedded in business-as-usual

These reports provide some useful guidance on what firms need to be doing. Therefore, private banks should take a look at their conduct risk frameworks and benchmark them against FCA expectations.

Benchmarks: New ESMA Q&A for Users

ESMA updated its EU Benchmarks Regulation (BMR) Q&A document on 24 May 2018, to include a new Q&A on how references to the ESMA register of administrators and benchmarks should be included in approved prospectuses. Such references are required to be included pursuant to Article 29(2) of the BMR, which provides that if a prospectus relates to investments that reference a benchmark, the prospectus must include clear and prominent information stating whether the benchmark is provided by an administrator included in the ESMA register.

ESMA's answer sets out the position as follows:

Type of prospectus / date approved	**Prospectus approved on or after 1 January 2018**		**Prospectus approved prior to 1 January 2018**
	Administrator already on the register	**Administrator not yet on the register**	
Prospectus Directive	Prospectus should include a reference to the fact that the administrator is on the register.	Prospectus should include a statement to the effect that the administrator is not on the register. Prospectus not necessarily required to be updated once the relevant administrator appears on the register, but should consider the significance/ materiality of the situation.	Prospectus not necessarily required to be updated once the relevant administrator appears on the register, but should consider the significance/materiality of the situation.
UCITS Directive	Prospectus should include a reference to the fact that the administrator is on the register.	Prospectus should include a statement to the effect that the administrator is not on the register. Prospectus should be updated at the first occasion once the relevant administrator is included on the register.	Prospectus should be updated before 1 January 2019 at the latest. If the relevant administrator is not on the register by this time, the prospectus should be updated to include a statement to that effect.

TechTrends: DLT to Help With KYC?

A recent discussion paper published by the Whitechapel Think Tank (a network of industry, regulators, academics, and UK government representatives set up to consider the application of new technologies in the financial services industry) explores how distributed ledger technology (DLT) could provide a solution to the costs and inefficiencies associated with customer identification processes. The paper highlights that, as technological developments enable more efficient means of transacting, so must they support a more efficient and robust system for establishing and validating identities.

The paper also explains that DLT, which enables a decentralised approach to sharing sources of data that are used to undertake proof of identity, has the potential to address many issues in this area. In particular, the fact that customers often have to produce the same information and documents time and again to different firms in order to verify their identities. If deployed correctly, use of DLT would leave the data subject in control of their data, allow proof of identity to be decentralised rather than maintained in a central authority (meaning potentially less risk), and also offer the opportunity for firms to commercialise the due diligence work that they already undertake.

The paper finds that there are two potential approaches to using DLT to make proof of identity processes more efficient and effective.

The first approach is for all institutions to rely upon a standardised proof of identity that is universally recognised as authoritative in a particular context. This would enable firms to draw on a common source, rather than each having their own processes. So, for example, participating firms could all access authoritative data on a customer, rather than each firm needing to verify the customer's identification data separately.

The second approach is for all institutions to use a standardised metadata management layer, allowing permissioned access to shared data and service layers. This data could then be used to meet the standards required in various different contexts. The underlying data would not be stored in the ledger, and this approach would require firms to request relevant data on a non-reliance basis if needed, as well as related services such as authentication and analytics.

> *"The paper highlights that, as technological developments enable more efficient means of transacting, so must they support a more efficient and robust system for establishing and validating identities".*

The discussion in the paper is very much exploratory thinking at this stage, and there would be many wrinkles to iron out in setting up a viable and usable solution in practice. The potential for transforming current processes is evident, and this paper offers up some interesting food for thought.

Cryptocurrencies: FCA Dear CEO Letter Warns of Financial Crime Risk

With cryptocurrencies increasing in popularity and garnering more regulatory attention, the FCA published a "Dear CEO" letter on 11 June 2018. The letter sets out good practices for how banks can handle the financial crime risks that cryptocurrencies pose.

The FCA stresses that banks should take reasonable and proportionate measures to lessen the risk of facilitating financial crime. Cryptocurrencies may enable crimes such as money laundering, given that they often lend themselves to anonymity.

The FCA suggests that if a bank offers services to clients who derive significant business activities or revenues from crypto-related activities, enhancing scrutiny of these clients and their activities may be necessary. Banks might consider measures such as:

- Developing staff knowledge and expertise on cryptocurrencies, to help them identify the clients or activities that pose a high risk of financial crime
- Ensuring that existing financial crime frameworks adequately reflect the crypto-related activities that the firm is involved in, and that these frameworks are capable of keeping pace with fast-moving developments
- Engaging with clients to understand the nature of their businesses and the risks they pose

Banks are also expected to carry out proper source of wealth checks on customers whose wealth or funds derive from the sale of cryptocurrencies, or other cryptocurrency-related activities. The FCA stresses that although the evidence trail may be weaker in relation to cryptocurrencies than for other sources of funds, this does not justify applying a different evidential test. The FCA also flags that a particular high-risk indicator would be a customer using a state-sponsored cryptocurrency that is designed to evade international financial sanctions.

Banks also need to be alive to the risk of retail customers contributing to initial coin offerings (ICOs) potentially falling victim to investment fraud.

Given the likelihood of more banks becoming involved in the crypto world, they must be cognisant of the risks, and proactive about establishing further measures to counter the additional threats.

MiFID II: FCA to Review Implementation of Rules on Research and Corporate Access

At the FCA Asset Management Conference on 12 June 2018, the regulator announced that it will begin a review of firms' implementation of the new MiFID II rules on research unbundling and corporate access. This is the first significant piece of MiFID II post-implementation work the FCA has announced.

The regulator is concerned about whether firms are following the spirit of the rules for pricing research and corporate access services. In particular, the FCA is concerned that unduly favourable pricing means that some services should properly be classed as inducements and be subject to the associated rules.

> The FCA will be reaching out to firms in the coming weeks, and expects the review to take around six months.

Lessons from Enforcement: The FCA's Enforcement Agenda

Recent FCA publications and speeches provide useful insight into the FCA's enforcement priorities in the short- to medium- term. Other publicly available material shows that the FCA's appetite for enforcement (and criminal prosecution) is undiminished.

What is the FCA's new approach to enforcement?

The FCA's response to a Freedom of Information Act enquiry in March 2018 shows that there were 468 open enforcement investigations in late February 2018, of which 306 were into individuals, including five into individuals holding senior management functions (one of which has since been resolved). The remaining 160 investigations concerned firms. That is a significant increase in investigations on previous years (up 75% in 2017 on 2016).

> *"The FCA's new approach is to open an investigation whenever the regulator suspects serious misconduct may have occurred. In practice, this means investigations start at an earlier point in time, when the facts are still unclear".*

This increase is consistent with Latham's experience and with anecdotal evidence from the firm's clients. More importantly, the increase is consistent with rhetoric in various speeches by Mark Steward, the FCA's Director of Enforcement and Market Oversight. These speeches set out the FCA's approach to enforcement in response to, amongst other things, Andrew Green QC's Report on enforcement action by the Financial Services Authority (the FCA's predecessor) following the collapse of HBOS in 2008.

The FCA's new approach is to open an investigation whenever the regulator suspects serious misconduct may have occurred. In practice, this means investigations start at an earlier point in time, when the facts are still unclear. Arguing with the FCA's approach is difficult in principle, provided the regulator is going into investigations with an open mind. Mr. Steward has said they are — and Latham's experience (which is not universally shared based on conversations with clients) tallies with this, noting the FCA's more mature and balanced approach to some investigations.

This includes deciding not to pursue enforcement action against firms and individuals if the facts suggest that perceived misconduct did not reflect misconduct or failures of systems and controls, but was simply a function of the fact that, even in the best-run firms, things sometimes go wrong. The regulator's approach is encouraging — as is the fact that the FCA has been ready to tell firms that they do not intend to pursue enforcement action, so that investigations are not left hanging over the heads of firms and individuals for an indeterminate period. This (as Mr. Steward has acknowledged) is a criticism that has been levelled at the FCA in the past. As noted, though, this is not a universally shared experience according to some clients.

Which areas are FCA investigations targeting?

Private banks should focus their efforts on three main areas, to avoid attracting attention from the regulator:

- **Capital markets disclosures:** exemplified by the enforcement action against Tesco in March 2017, these disclosures are perhaps of less concern to private banks.
- **Market abuse:** partly in response to increased levels of reporting by market participants under the Market Abuse Regulation (MAR), private banks should pay close attention to this area.
- **Money laundering:** partly connected to market abuse, but also driven by the Financial Action Task Force's (FATF's) on-going evaluation of the UK's anti-money laundering (AML) and counter terrorist financing (CTF) regime, which will result in a report later this year. The fear is that the FATF will conclude that — despite the rigours of the UK AML and CTF regimes in theory — the absence of enforcement action and criminal prosecutions in one of the world's major financial markets indicates that insufficient action is being taken to identify and penalise firms and individuals who fall short of the standards required.

If Latham had to identify one area where private banks (who are perceived as being particularly exposed to the risk of money laundering) should be kicking the tyres hard in the coming months, it is the area of AML and CTF systems and controls, because the risk of enforcement action (including criminal prosecution) is particularly high in the current climate.

What to Look Out for in Q3 2018

- UK government and financial services regulators expected to start publishing draft legislation and regulation in relation to the “onshoring” of EU financial services legislation
- Deadline for compliance with the MiFID II systematic internaliser regime on 1 September 2018
- FCA expects to publish a Discussion Paper on whether to introduce a duty of care for financial services firms
- FCA plans to publish a Consultation Paper on introducing a public register for individuals falling within the Certification Regime

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