Ep. 29: What UK Authorized Firms Need to Know

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Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

In Principle is a report produced annually by Akin Gump whose subtitle—10 Things Authorised Firms Need to Know—describes both its target audience and its mission. This year's edition, released at the end of January is no different, as it outlines key areas that authorized firms, in other words, firms given permission by the U.K.'s Financial Conduct Authority to provide regulated products and services, should be watching as this year advances.

We have with us today Akin Gump financial regulatory partners Helen Marshall and Ezra Zahabi, and they'll be taking us through the In Principle report and discussing some of the salient points, bringing to the conversation their own valuable practitioners' insight and experience.

Helen served as head of enforcement at the Financial Services Authority, the precursor organization to the FCA, while Ezra works closely with all the players involved in the U.K. and EU financial services regulatory frameworks.

Welcome to the podcast.

Helen, Ezra, thank you both for appearing on the show today. The *In Principle* report contains, as advertised, 10 key topics of interest for authorized firms and those working with them. So let's dive right in.

To start, can we look at a few overarching themes that we might be able to tease out of these 10 topics? Brexit, certainly a first among equals in this regard. So, could you discuss it and some other big themes for U.K.-authorized firms. Ezra, if you would, please.

Ezra Zahabi: Sure. So, Brexit clearly is, and continues to be, a big theme. Interestingly, in 2020, and probably in the course of 2019, what became apparent was that firms had probably, most firms in any event, gone through the process of looking at their contingency plans and thinking about what arrangements they might need to have in place in case of a no-deal Brexit.

I think what's happening at the moment is firms shifting their attention in trying to work out not only their very high-level, big-ticket structural issues, but also commercially and in terms of market expectation, really, what they're going to do in the longer term, especially as a prospect of a no-deal Brexit—or a Brexit deal that does not provide the kind of equivalency and market access as firms may have hoped for—becomes more likely.

And, so, I think that, in terms of Brexit, people are starting to look at things like contractual implications, things like structural issues around trading frameworks, as well as just market expectations as to where managers might be located, and regulatory expectations in different jurisdictions.

So, some of the things that people have been discussing and that are potentially problematic, something that takes up a lot of time, are local substance requirements. The particular question is around the viability and the long-term future of the kind of platform turnkey managers that offer a structural option in the European Union after the U.K.'s withdrawal.

Jose Garriga: Helen, what do you think about overarching themes in this regard?

Helen Marshall: I think I come at it from probably a slightly different place, because my practice, which I think we might talk about a little later, is more on the enforcement contentious side. And I think one of the key issues for authorized firms in the year ahead is going to be the bedding down into practice of the new senior managers and certification regime. That regime has already been in place for banks in the U.K., but at the end of 2019, it came into force across the whole of the financial services industry, and businesses have a little bit of time to make sure they are properly ready to implement it.

But that is something that we're going to see taking time on the part of the authorized firms and also potentially being a focus of the regulators as the year progresses, to look, really, at whether firms are properly implementing it and then, indeed, looking at whether there has been any miscreant behavior by anyone who is a senior manager, and the FCA potentially looking at bringing some enforcement cases to encourage everyone to behave properly. So, from my point of view, that, I think, is one of the big themes for the year ahead.

Ezra Zahabi: And I'll raise a couple of other themes that are sweeping through the industry, some of which will likely become bigger issues in the course of 2020 than others. Those include sustainability, in an asset management and institutional investment context, then various revisions and rewrites of European regulations.

So, there have been revisions to the cross-border distribution provisions under the AIFMD, which is the Alternative Investment Fund Managers Directive governing the marketing and management of funds in the EU, and especially the marketing piece has been subject to some revisions. Also, revisions to EMIR [*European Market Infrastructure Regulation*] which is the piece of EU legislation that governs derivatives trading in the EU. So, there's been some rewriting of those provisions and, particularly, the introduction of further thinking around the appropriate counterparty categories.

And then the whole-scale introduction of the Securities Financing Transactions Regulation, which, basically, introduces a similar reporting and obligation framework for firms that enter into securities financing arrangements. So repo, reverse repo, securities

lending, that sort of thing. And I think that looking further to the horizon, we see that there's a likely MiFID III [*Markets in Financial Instruments Directive*] in the works at the moment, and they are going to be further revisions to other European legislation as well. And, so, how that really plays out with Brexit remains an interesting point to look to in the future.

Jose Garriga: Thank you. Speaking of looking to the future, let's look at the upcoming year, then. As I mentioned, *In Principle* features 10 topics. The first one is one that's generated a lot of articles, a lot of buzz, a lot of discussion in recent months, and that's environmental, social and governance considerations. How is ESG relevant to investment managers? Ezra, what do you think?

Ezra Zahabi: That's very interesting. So, I think that there's a couple of ways, actually, in which it's relevant. In the EU, ESG has really risen to the top of the political agenda. And principally the primary topics. ESG is a pretty broad church, so it's environmental, social and governance. All of those issues are relevant, and they remain regulatory concerns and political concerns. The very urgent aspect of that, at the moment, is the focus on climate change and how to harness finance effectively in support of structural changes within the economy that improve economic performance in manufacturing fields, in all of the other real economy fields, not simply in finance, and support the effort at transforming the way that we operate and produce structurally in a society and to effectively improve our preparedness for climate change and mitigation of those risks.

Further, another way that ESG issues are relevant, in particular in the climate change context, is that there's been an introduction of disclosure requirements, both in the FCA rules on a disclose, or a comply or explain basis. So, you have to either disclose or explain why you're not disclosing, but those disclosure requirements currently are principally in the context of explaining shareholder engagement. And, so, for example, if there was a material vote on director compensation or approving particular types of transactions or voting on issues that perhaps other shareholders have put on the agenda, managers are, in principle, required to report and make public information about how they've exercised their votes. So, that might be relevant, in particular where climate change related issues find their way on the agenda.

And then another way that ESG is relevant is that there are also other voluntary codes, like the UK Stewardship Code, that have recently been revised, again, with a view to providing a lot more transparency to the market about certain key areas, like how votes are exercised, but also internal policies and processes. And, so, the idea is that there will be, both on a voluntary basis and on a rule basis, much more information available in the public sector to investors, who will then take that information and consider how the investment managers are actually performing in terms of taking into consideration climate change when they make their investment management decisions.

Another way in which ESG will be, and will become, I think, increasingly relevant to investment managers is that there's legislation that's directed, and is applicable to, the institutional investor base. The issue, I think, is that institutional investors, such as occupational pension schemes and life insurance companies, are under their own obligations to both make information publicly available or perhaps some other duty obligations. So, for example, the U.K. occupational pension schemes, they have various duties under the relevant legislation, and there've been some revisions to the law defining those duties such that they are now required to consider their duties, the trustees of occupational pension schemes are required to consider their duties with regard to climate change, for example.

Although you might think that the actual change is relatively minor and doesn't clearly set out a framework as to what the occupational pension schemes and their trustees are actually required to do, it is an expectation of the Pensions Regulator, for example, that wrote to a number of the large U.K. occupational pension scheme trustees asking them what they intend to do, that there will be some material changes or tangible changes to the investment policies, and the way that institutional investors are handling their external investment management relationships. And I think that there's going to be a greater expectation that investment managers are able to give chapter and verse on exactly what they're doing, and also provide, not only the policy and qualitative information, but also, over time, more hard data and more quantitative information about how they consider climate risk, how they take into consideration the environmental concerns when they make their investment decisions and how that ultimately plays out in the performance of the investment portfolios under their management.

So, I think that there is, at least perceived to be, currently a tension between, on the one hand, the need and the desire to invest more in green investments or move investment away from fossil fuels and other things that are considered to be harmful from an environmental perspective, and, on the other hand, having actual data to show this is what manager is actually doing and also data to show how the environmentally friendly investments are performing.

Jose Garriga: Thank you. Let's move to a topic, I think, Helen, that is squarely in your wheelhouse, and that's enforcement. It's a topic of interest and concern on both sides of the Atlantic, certainly. But what should listeners know about trends in this regard, particularly as concerns the Financial Conduct Authority, and are there bellwether cases to watch?

Helen Marshall: Across enforcement, generally, trying to pinpoint bellwether cases or spot trends is always quite difficult, because, of course, there's a lag and a delay between those areas that the regulator is saying are important as of today's date and then the publication, ultimately, of enforcement cases against firms and individuals for having breached those particular areas.

So, the types of cases that are coming up now and becoming public now tend to be the things that were important to the FCA two, three, four years ago, simply because of the time that it's taken for those cases to be investigated and brought. I mentioned earlier the Senior Managers and Certification Regime, and I think that's a good example of this.

That regime has been already in place in relation to banks since early 2016, and yet, in those four years since that regime has been in place, there's only been one sanction actually issued against a senior manager. That was in 2018; the FCA sanctioned the CEO of Barclays in connection with a breach of his obligation to act with due skill care and diligence in relation to a whistleblower issue. And we anticipate that, with the rollout of SMCR to all FCA-regulated firms, which took place in December 2019, the FCA is going to be very keen to show, as soon as possible, that the new regime's actually got some teeth. And, so, we are expecting there will be more cases being brought against individuals.

So, that's either those people who are senior managers, or more junior people employed within businesses as certified staff for whom the firm has taken responsibility for oversight. When we looked at the last data the FCA published on the type and number of investigations they had on hand, we know that, in the middle of last year, they already had, I think, 15 open investigations into senior managers. And, so, I am anticipating that,

during the course of this year, at least a few of those investigations will turn into real enforcement cases for the FCA, from which firms will be able to review and see the types of behavior the FCA really strongly disapproves of.

Beyond that issue, so beyond the Senior Managers and Certification Regime, I think it's worth noting that the FCA is opening more cases and actually also closing cases and shortening the amount of time that it takes for cases to work their way through the regulatory system. The FCA has also identified a number of key areas that it will be looking at closely in the forthcoming years, and they are the usual areas that you would expect, including, for example, anti-money laundering controls, markets abuse, but also culture and governance being very important to the FCA as well as operational resilience issues. And I think that issue links across through to cybersecurity and other data security-type issues and technological issues.

Jose Garriga: A reminder, listeners, we're here today with Akin Gump financial regulatory partners Helen Marshall and Ezra Zahabi discussing what authorized firms need to know for 2020.

So, let's turn now to a topic that is a perennial concern, which is cybersecurity. Over the last year, cyber issues only gained urgency and relevance for the business community. How does the cyber threat, and the need for data protection, look to play out in 2020? And what impact has GDPR had, and look to have, on this sector? Ezra, what do you think about that?

Ezra Zahabi: That's a good question. So, interestingly, of course, I think that it's statistically well documented that the rate at which cybersecurity attacks occur makes it probably, actually, at the moment, the most prominent single threat to individual financial institutions and firms operating within the financial services sector. It is the case that, in the U.K., as well as in other EU jurisdictions, the regulators are very aware of this. So, cybersecurity has an overlap with GDPR. And, so, whereas GDPR is principally concerned with the protection of individuals' personal data, and, clearly, in some instances, that's totally relevant to a cybersecurity attack. So, for example, when there's an attack that digs out information about individuals and their financial information in a database, that will be a breach of the cybersecurity measures that a firm has put in place that the regulator, the financial regulator, may very well be interested in to the extent that that shows undue weakness, I guess, in the systems and controls at the firm.

And it's also a really clear business threat. We have witnessed quite a few instances in which funds, or administrators of funds, have received fraudulent requests, or there's been a fraudulent communication interception between the communications of an investment manager, administrators of the fund, custodians. And, so, it's definitely something that is happening more and more. I don't know that it has actually risen within the investment manager community. I think that individual investment managers are quite aware of it, but because investment managers themselves very often don't actually hold assets, conventionally, they have not been perceived as being a prime target of cybersecurity threats apart from things like loss or breach of the security of databases that can contain proprietary information. But I think that that is changing.

One of the key things that GDPR really did, apart from the great thing of enhancing the protection of individuals' personal data, it upped quite considerably the potential financial penalties that arise in a situation where there has been a data security breach. And, so, that alone created some focus by the firms on their internal cybersecurity measures and the way in which they actually protect and process data, whether it be personal data or

financial data. And very often, those two, of course, are interlinked. And, so, I think that there have been a couple of instances of FCA investigations that have a data protection dimension, or a cybersecurity dimension. And I think Helen can probably speak to it better than I can, but it's definitely something that's just a practical concern. And it will grow, I think, as a practical concern for firms.

Helen Marshall: On the enforcement side, there's a couple of interesting developments which are that, I think in 2018, the FCA brought a significant case in relation to Tesco Bank on a data breach where they alleged that the bank had failed to protect customer information. But actually, the FCA itself is also facing a few challenges in this area. So, the FCA is currently actually investigating a security breach at the Bank of England in relation to data that has been made publicly available.

And very recently, the FCA has had to refer itself to the Information Commissioner for accidentally revealing personal information of about 1600 people when it published, in response to a Freedom of Information request, the names and addresses of everyone who had complained about the FCA in a recent period. So, rather ironically, the FCA is now finding itself having problems with GDPR in the way that it will be seeking to expect that firms would not have such problems. So, interesting times for the FCA, I think, in connection with those issues. And it just shows the challenges and the difficulty of ensuring that, across your whole organization, these issues are really treated very carefully whenever information is published.

Jose Garriga: Indeed. Thank you both. Let's turn to something that I think had been raised earlier, which is AIFMD, the Alternative Investment Fund Managers Directive. New rules were adopted last year that relate to the cross-border distribution of investment funds. As these get set to take effect next year, how do you view AIFMD in this post-Brexit environment? Ezra, please.

Ezra Zahabi: Again, very interesting question. I think that there are a couple of things there. One is that, just from a purely practical perspective, from those investment managers, in terms of the marketing—which is what the new rules on cross-border distribution relate to—while it is possible that there will be a divergence of either rules as they are written, less likely perhaps, or, possibly more likely, the way in which those rules are interpreted at a local level, that divergence exists frankly already between the U.K. and other EU member states. I think that most managers will continue to market to institutional investors in other EU jurisdictions. I think that there is likely to be some divergence between the way that the U.K. will read the rules. So, technically, the way that the current withdrawal arrangements are put in place, the rules that are currently EU law, were EU law on the date that the U.K. withdrew from the European Union, and that are put in place during the implementation period which is until the end of this year, those continue to be good U.K. law.

It is, of course, then a separate question as to whether those rules over time, as in when they have revised in the EU, will also be revised in the U.K., or if there will be other developments. For example, in the U.K. courts, that mean that those rules are interpreted in a different manner from the way that they would be interpreted by ESMA, for example, or the European Court of Justice. So there's a question mark there. As a practical matter, I think that it is likely that firms, both in the U.K., and outside the EU altogether, like in the U.S., they'll need to consider AIFMD as it’s implemented in the EU, because that's where a lot of the investors will continue to be located.

And, so, those new rules that are purported to harmonize the way that the marketing rules apply and to make marketing easier, as is often the case when the European Union tries to make things better, it introduces probably more complexity than is currently the case. On the other hand, I think that, at the very least, it does introduce a concept of pre-marketing, which, at least, suggests that not all commercial promotional communications with investors are considered marketing for AIFMD purposes and, therefore, don't trigger the regulatory registration requirement.

And, so, there is some leeway for discussions with investors for interest-gauging purposes before a registration is required. It is probably the case that, in the U.K., that leeway exists already. So, the new rules are unlikely to create more freedom for communications. What they do create is a new notification obligation, albeit a fairly informal one. So, I think that, even in a Brexit context, the U.K. will continue to apply the AIFMD. I think that it will continue to apply the new cross-border distribution rules. But, in the longer term, there's a real question, I think, as to what AIFMD, as implemented in the U.K., looks like, and what AIFMD looks like in other EU countries.

Jose Garriga: Thank you. Let's turn briefly to something Helen had mentioned earlier, which was the fact that she approaches regulatory issues from a contentious angle, and you, Ezra, from the noncontentious angle. How would you concretize a distinction between these and the work you do, in the context of the material covered in this In Principle report? And what should listeners know about the upcoming year in the areas covered by your respective disciplines? Helen, if you'd take the lead on that.

Helen Marshall: Sure. I think we're quite an interesting financial services regulatory practice in the City, because we operate as one team, although, as you say, I focus on contentious work, Ezra focuses on noncontentious work, but we do work very closely together. So, my practice is basically helping institutions, and sometimes senior individuals, who have some kind of problematic issue with the FCA. Whether that is just something happens to have gone wrong, and they're working out how best to tell the FCA about it, or they're actually under active investigation by the FCA, and we help them all the way through the enforcement case with the FCA. Often, my work's in the background, because, at an early stage, it doesn't necessarily always help clients to have a lawyer on the record with the FCA. But my work is about trying to help clients manage what can sometimes be quite a fractious relationship with the FCA when something is either at risk of going wrong or has actually gone wrong.

And I think Ezra can talk more about her practice, but that is largely helping clients to ever avoid being in that situation in the first place. That's quite an area of overlap in our work. So, one of the things that we quite often advise on together, for example, is queries around the Market Abuse Regulation, which, in the EU, is the regulation which governs insider trading and market manipulation. And we regularly talk to clients in a real-time basis around potential transactions trades they are contemplating across European jurisdictions, where the European regulators, including the FCA, would take a view of whether that behavior might be problematic. And we help those clients understand the way in which the regulator might potentially look at those proposed activities.

And I think, with a view to thinking about our client base here, one of the key takeaways for clients is to remember that the U.S. and U.K. jurisdictions in relation to insider trading are actually quite different. And, so, if there is any involvement of an EU-listed stock, then the need to think more widely, and think about the European regulation, is something that really should be at the forefront of businesses' minds and isn't always

because they're often so used to just dealing with the American jurisdiction, and it is quite different. Ezra, anything you'd also say about the way our practices merge together?

Ezra Zahabi: Well, I think that I very often, in fact, go and talk to Helen to get the enforcement regulator's perspective on what might be issues when we work through pragmatic solutions to problems that clients might be facing. And, so, I advise them on the often very ambiguously drafted, very broadly ranging, purposively interpreted EU legislation on lots of different areas. And the balance that we try to strike is really looking at the very practical commercial issues that clients have, looking at how the rules actually work, what their objective is, how they're phrased, what are the practical issues that clients face, and then suggesting different solutions.

And I think that it is incredibly useful for us, in that advisory practice, to have access to the kind of benefit of hindsight that the regulator very often then utilizes when it looks at firms and their conduct and takes a view as to whether or not their conduct has been subpar or not. It's important, actually, as a regulatory lawyer, to not only operate in an echo-chamber way where you convince everybody in the room that this is absolutely fine without getting somebody's skeptical and challenging view, which is exactly the view that the regulator will have if there's a problem. And, so, I think that's incredibly valuable in the advisory practice to have access to that contentious perspective.

Jose Garriga: Thank you. So, let's wrap up now with just some takeaways for listeners, and what short- to medium-term takeaways can you offer listeners working in and with authorized firms in the U.K. within the context of the material covered in the In Principle report, and just more generally? Helen, if you would, please.

Helen Marshall: Sure. We've talked about some of the key themes that the regulator is going to be looking at and that are around in the sector for the year ahead. But just as an overall takeaway, I would say that firms should take any interaction they have with the regulator very seriously at the outset, not allow things to drift along, to think quite carefully about how they report things that may have gone wrong within their business. One of the obligations that firms have here in the U.K. is an obligation under what's called Principle 11, which is an obligation to bring to the attention of the regulator anything that the regulator would reasonably want to know about. And that's very, very broad and strikes, I think, terror into the hearts of some of our U.S. colleagues and clients when they first hear about it. But the way in which clients manage interactions, including notification of issues, is really, I think, quite important and can prevent worse interactions later in the day. So, I think that's a key takeaway that I would suggest.

Ezra Zahabi: And I think that, on the noncontentious advisory side, I think that a couple of fairly short-term issues are around the phasing out of libel, and the introduction of the replacement benchmarks. And, so, that is, frankly, work that is quite labor intensive, and that a lot of investment managers have not really engaged with. And I think that the FCA has repeatedly made calls to the financial services sector to make sure that they have in place appropriate contingency plans and appropriate processes in order to amend the relevant documentation and to think through what the issues are. And I think that the FCA is very, very aware of the fact that there has been a considerably lower level of uptake in engagement than they would expect. And, so, I think that that is something that may well catch some of the firms unawares.

And then, I think, the other thing is really trying to get people engaged in thinking about really how to work through ESG in terms of their operations and the way that really

applies to them. I think that the various EU initiatives, they are pretty clearly aimed at the fairly easily identified investments, so I think that they're helpful in terms of trying to standardize information around the environmental impact of investment in fossil fuels or manufacturing or building sectors or mining, that kind of thing. But there's a more complex analysis, I think, that firms eventually will need to undertake when they really think about what risk means, and how that risk is actually worked through their existing risk mitigation and management and identification policies and programs.

Jose Garriga: Thank you. Listeners, you've been listening to Akin Gump financial regulatory partners Helen Marshall and Ezra Zahabi. Thank you both for making the time to discuss and analyze these topics of interest to our audience on both sides of the Atlantic.

And thank you, listeners, as always, for your time and attention. Please make sure to subscribe to OnAir with Akin Gump at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, SoundCloud and Spotify.

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Until next time.