Financial Regulation Monthly Breakfast Webcast

12 February 2025

LATHAM & WATKINS

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The FCA’s report on the risks of money laundering through capital markets and related portfolio letter to wholesale brokers

Jonathan Ritson-Candler

Assessing and reducing the risk of Money Laundering Through the Markets

- On 23 January 2025, the FCA published the findings of analysis it has done on Money Laundering Risk Through the Markets (MLTM)
- MLTM is:

  "*The use of capital markets to launder funds obtained through criminal activity, so that they appear legitimately generated from trading activity*"
- Continuation of TR19/4 from 2019
- A mixture of data and findings
- Primarily helpful as a benchmarking exercise, alongside TR19/4, for <u>brokers of all sizes</u> to use to check their AML and CTF processes

Assessing and reducing the risk of MLTM (cont.)

- **Risk typologies**
  - Provides a range of MLTM-specific fact patterns with inherent ML and TF risk
  - Builds on worked examples from TR19/4
  - Brokers should use these to review risk assessment and include relevant examples in AML and CTF systems and controls and training
- **SARs to utilise specific MLTM glossary codes**
  - Detailed analysis on use (or lack thereof!) of specific codes when filing SARs for suspicions of MLTM
- **Brokers' Business Wide Risk Assessments (BWRA)**
  - FCA notes that a high proportion of BWRA it reviewed did not consider terrorist financing or proliferation financing risks
  - Examples of good practice include a BWRA that scores risk factors between 1 and 5 (for impact and probability) to create inherent risk score
  - Total inherent risk score divided by the number of risks = total inherent ML, TF and PF risk to which the firm is exposed
  - The residual risk is calculated by multiplying overall inherent risk by perceived strength of controls = residual risk

Assessing and reducing the risk of MLTM (cont.)

- **Customer risk assessments (CRA)**
  - FCA expects CRA to be performed first to determine level of CDD
  - Good practice includes a CRA with risk scoring against variously weighted categories (e.g., product and service, geography, customer type, PEP status, adverse media etc.)
  - Total risk score per category is multiplied by the weighting to give risk rating as high / medium / low, which then determines level of CDD
- **Customer Due Diligence (CDD)**
  - Most firms use 1/3/5-year CDD refresh cycle based on risk rating (albeit see above)
  - FCA cites good practice as including ongoing PEP, sanctions and adverse media screening and CDD refresh if any alerts generated
  - Flags concerns with formal reliance being placed on other firms where the MLRs do not permit it and/or where formal agreements are not in place
- **Governance and oversight**
  - FCA provides examples of good quality MI – monthly packs containing AML monitoring information (e.g., customer rejections, number of new accounts by risk rating, top 10 high risk customers, screening figures and alerts, periodic review backlog, SARs, quality assurance results etc.)
  - Flagged in some smaller firms SMF16/17 may not have requisite experience

Assessing and reducing the risk of MLTM (cont.)

- **Transaction (ongoing) Monitoring (TM)**
  - Observes that firms find it easier to identify possible market abuse (via trade surveillance) compared to potential ML, TF and/or PF (via TM)
  - TM tools still nascent compared to market abuse trade surveillance
  - TS and TM likely to be complementary but avoid conflating the two
  - Provides examples of best practice of collaboration (and delineation) between functions (e.g., shared reporting lines, integrated teams, collective MI reporting, share alerts for read across etc.)
  - Key areas where firms should investigate use of AI
- **Investigations and Suspicious Activity Reporting (SARs)**
  - FCA has data indicating nearly 75% of brokers have not refused or exited any clients for ML, TF or PF issues and have not filed SARs
    - Consider reviewing processes if no or very few SARs submitted
  - Avoid conflating STORs and SARs and have process in place to consider submitting one or both
  - Be cognisant of NCA guidance on good quality SARs
- **Training, resourcing and policies and procedures**
  - Training should not be generic and should be tailored to brokers
  - Consider cross training TS, TM, AML and front office staff together

Portfolio letter to wholesale brokers

- On 24 January 2025, FCA published a Dear CEO letter to its wholesale brokers portfolio
- By 31 March 2025, FCA expects CEOs to review the letter with the Board, how the risks apply to their business, and take any actions as necessary
- Notes consolidation in the market as a result of M&A and *“weaker mid-sized firms…exiting the market”* but with a *“strong core of specialist firms…[that] exist and thrive”*
- Flags a number of areas for review
- **Financial crime**: refers firms to TR19/4 and MLTM paper, as discussed. States that it expects firms to read the MTLM report in full and incorporate good practices, stop poor practices, and consider if any improvements to market abuse controls are also required

Portfolio letter to wholesale brokers (cont.)

- **Prudential risk management:** FCA notes it will publish observation paper on liquidity risk management framework shortly
- **Remuneration and broker misconduct:** flags concerns that some brokers have not implemented the Remuneration Code(s), leading to poor client outcomes (owing to profit generation being overly emphasised). The FCA has also observed instances of disciplinary action being taken against staff but with no impact on their remuneration
- FCA's supervisory strategy over the next 2 years:
  - Firms that fail to comply with updated rules will be subject to various action, including Board effectiveness reviews, increased capital requirements, and business restrictions
  - Focus on:
    - Culture: noting the FCA will use results of non-financial misconduct survey to contact outlier firms
    - Business oversight: reinforcing focus on remuneration tools for oversight including malus and clawback
    - Financial resilience: planning to test brokers' contingency funding plans

The PRA's supervisory priorities for banks in 2025

Rob Moulton

PRA international bank supervision: 2025 priorities

- Risk management, governance and controls
  - Industry has been tested by global interest rates, geo-political events and technological change (especially AI)
  - Firms vary in how well they have coped
  - Boards need to ensure the firm has leveraged stress and scenario analysis
  - Many firms fall short on Counterparty Credit Risk: non-financial bank financial institutions such as PE firms, new lending, areas of growth
- Data risk
  - Firms must improve their ability to aggregate data to produce better MI
  - Complete, timely and accurate regulatory calculations and returns matter to the PRA
- Financial resilience
  - Liquidity events in recent years have highlighted this
  - Has also led the PRA to rewrite their internal process for monitoring external pressures on bank liquidity
  - Boards should “seek assurance” from treasury about effectiveness of balance sheet management

PRA international bank supervision: 2025 priorities (cont.)

- Operational resilience
  - The looming March 2025 deadline is highlighted
  - Firms need to be able to prove their analysis of impact tolerances for important business services (severe but plausible levels of disruption)
  - Firms should also have made significant progress, and focused on cyber threats, legacy infrastructure, and third-party services
- PRA will consult H2 2025 on information and cyber risks
- Basel 3.1 delay
  - Transitional period start date delayed by 12 months
  - To enable “greater clarity to emerge about plans for its implementation in the United States”
  - Full implementation unchanged: 1 Jan 2030

The impact of recent US legislative change on UK financial market participants

Nicola Higgs, Arthur Long and Pia Naib

Trump Administration

Outbound investment rule

Effective 2 Jan 25

Prohibits or requires notification of certain investments by US companies and their foreign subsidiaries in "covered foreign persons" = Chinese and Chinese-controlled entities involved in semiconductors, quantum information technologies, and AI

Transactions in scope include: equity; debt financing; JVs, LP stakes

DEI

EO Titled "Ending Illegal Discrimination and Restoring Merit-Based Opportunity"

– Directs federal agencies to take steps to target diversity, equity and inclusion (DEI) practices in the private sector

– Section 4 of the EO directs each agency to identify up to nine opportune civil compliance investigations into various entities, including publicly traded corporations. Priority sectors include financial institutions.

Climate

EO Titled "Putting America First in International Environmental Agreements"

– Initiates process for U.S. to withdraw from Paris Agreement.

– Other agencies that had climate-related proposed regulation will likely terminate them or affirmatively decide not to regulate on those matters.

Tariffs

Companies in scope of MAR are closely monitoring the impact of the tariffs on their business operations and considering the need to make public announcements.

Trump Administration (cont.)

Potential areas of deregulation

- Consumer Financial Protection Bureau’s Regulatory Authority
  - Trump’s firing of CFPB Director Rohit Chopra and appointment of Russell Vought as Acting Director has effectively shut down the agency, with a pause on rulemakings, communications, litigation and other activities
  - The US banking sector has long criticized the CFPB for aggressive regulation by enforcement
- Climate Risk Management
  - Climate risk is not expected to be a priority for the Trump administration, so minimal developments in this area are expected. The Federal Reserve withdrew from the Network of Central Banks and Supervisors for Greening the Financial System and ended its climate stress test program for the largest US banks
  - A federal rule on Fair Access to Financial Services – which critics consider to be anti-ESG – that was finalized under the first Trump administration but paused by the Biden administration could be re-introduced

Trump Administration (cont.)

Status of Basel III Endgame

- Issuance of a Basel III Endgame re-proposal is likely to be delayed until after President Trump’s appointees to the FDIC board of directors and OCC have assumed their positions
- Any re-proposal is expected to reduce the amount by which required bank capital must increase when compared with the original proposal, but lobbying efforts by the banking industry to prevent stricter rules for US banks compared to their non-US competitors will continue
- In addition, a re-proposal will almost assuredly focus capital increases on the largest, most internationally active US banks, with domestic regional and community banks being largely or totally exempt
- The re-proposal will be subject to public notice and comment requirements, which means that any Basel III endgame rule will likely not be finalized before the second half of 2025

Trump Administration (cont.)

Increase in Bank M&A Activity and a More Transaction-Friendly Approach to Bank Consolidation

- The first Trump administration took a more transaction-friendly approach to consolidation
- With a new Comptroller of the Currency and a Republican-majority FDIC board of directors, bank M&A activity will likely increase as smaller players continue to face challenges from increased regulatory compliance costs and economic factors
- The most likely outcome is that the FDIC, OCC and DOJ revert to prior practices, but the outdated market definition for bank mergers is due for an update

FCA under pressure: recent dialogue between the FCA and the government

Nell Perks

FCA / government dialogue

- FCA's response to Treasury Remit letter
  - 14 November 2024: Recommendations for the FCA
  - 9 December 2024: *"How we are supporting growth, the development of our next strategy, and our international role and approach to risk"*
  - 16 January 2025: A New Approach to Ensure Regulators and Regulations Support Growth
- House of Lords Financial Services Regulation Committee
  - 27 February 2024: CP24/2 "*Our Enforcement Guide and publishing enforcement investigations"*
  - 18 April 2024: Letter from FSRC to FCA followed by call for evidence to examine proposals
  - 22 November 2024: CP24/2 – Revised proposals
  - 6 February 2025: FSRC Report – Naming and shaming: how not to regulate
- APPG on Investment Fraud and Fairer Financial Services' Report on the FCA
  - 26 November 2024: *"rock solid confirmation that there is something seriously wrong with the FCA"*
  - FCA's response: *"we're a very different organisation" "we wouldn't recognise the characterisation"*
  - 3 February 2025: Supplementary Report – *"necessary because of the unconstructive way the FCA has responded to the original report"*

Treasury remit letter

- Calls for regulators to fully embed the competitiveness and growth objective
- Four priorities:
  - Support innovative new firms and enable existing firms to innovate
  - Enable customers to access appropriate advice and products
  - Support firms in Net Zero transition
  - Positive experience for firms engaging with regulators, including streamlining administrative burden
- FCA confirmed that growth will be a cornerstone of its strategy for the next five years
- FCA seeking a consensus with government on appropriate risk appetite
- Nikhil Rathi to Financial Services Regulation Committee / FCA letter – 16 January:
  - *Enabling more informed risk-taking requires enduring acceptance, as the Chancellor has recognised, that we need to prioritise resources and that there will be failures. This acceptance needs to be shared across all our accountability mechanisms, including in Parliament. We will not stop all harm when making risk-based choices about the cases and intelligence we pursue, and we increasingly deploy technology to make those choices with speed and at scale. Metrics for tolerable failures within the overall system could help to support this*

CP24/2 – Financial Services Regulation Committee

- *"How not to regulate"*
- Key findings and recommendations
  - Lack of engagement with stakeholders was unacceptable
  - FCA's explanation for how these proposals will further its objectives is unconvincing (in the context of its existing powers)
  - FCA must be able to demonstrate that the regime is underpinned by robust, fair and proportionate processes for assessing the "public interest"
  - FCA's assertion that the proposals were consistent with international regulators' approach was misleading
  - Lack of cost benefit analysis has contributed to industry concern
  - FCA should review internal processes and communications strategy and publish a "lessons learnt" document
  - FCA needs to be able to show that stakeholders' concerns have been addressed by the new proposals
  - If the FCA does not find an acceptable balance, it should not proceed with the proposed changes

APPG on investment fraud and financial services

- APPG called for evidence to understand whether the FCA is:
  - Providing appropriate customer protection
  - Delivering good outcomes
  - Enabling redress for historic wrongs
- Concluded that meaningful change must happen
- 26 November 2024 speech in Parliament:
  - *"Any response by the FCA that is in any way dismissive of this report would also be terribly disappointing, and point once again to the continued state of denial that it seems to be in"*
- Supplementary Report focuses on:
  - *FCA response through internal communications*
  - *FCA response through statements in the press*
  - *FCA response through Board Meeting minutes*
  - *"It is worrying that a consistent theme is emerging, namely the very stark contrast between the findings of research about the FCA that the FCA has organised itself […] and what the independent people the APPG has interacted with, think about the FCA"*

APPG on investment fraud and financial services (cont.)

- Supplementary report: first instalment in a series that make up the entirety of the report
- Key conclusions:
  - Original report was a serious attempt to wave a red flag that there is something seriously wrong with the regulator
  - FCA’s unwillingness to engage with elected representatives and other Parliamentarians is unacceptable
  - Former City Minister’s statement that she had confidence in the FCA may prove an error of judgment
  - APPG is continuing to share new evidence to show the serious issues identified are not just historic
  - Nothing has happened to change the view that the FCA is “incompetent at best, dishonest at worst”
  - Important to growth prospects of FS sector that trust and confidence in FCA is regained
- Next steps:
  - New evidence to continue to be shared
  - Meaningful debates in Parliament

An update on UK and EU benchmark regulation

Becky Critchley

EU BMR

- Political agreement on amended EU BMR reached on 12 December 2024
- Amended EU BMR will apply from 1 January 2026
- Key changes to scope include:
    - Exclusion of (most) non-significant benchmarks
    - In scope:
        - Critical and significant benchmarks
        - CTBs and PABs
  - ESG benchmark disclosures
  - Updated regime for commodity benchmarks
  - Increased role of ESMA

UK BMR

- EU BMR onshored following Brexit
- Transitional provisions for third country benchmarks extended until 31 December 2030
- No current proposals for review

Recent Thought Leadership

- [The Tides Are Changing For Fair Access Banking Laws]
- [FDIC Acting Chairman Charts a Fresh Path Forward for the Agency]
- [Regulatory Reversals: Political Transitions and the Congressional Review Act]
- [European Banking Authority Launches Consultation on Guidelines on ESG Scenario Analysis]
- [EBA Publishes Final Guidelines on the Management of ESG Risks]

Monthly London Webcast Materials

Each month the UK and European Financial Regulatory lawyers at Latham & Watkins host a presentation and discussion covering recent changes to financial services regulation.

VIEW

10 Key Focus Areas for Financial Services Firms in 2025

In this publication and podcast series, we explore some of the core focus areas for UK-regulated financial services firms in the year ahead.

The Report

Click the laptop to read the report

Podcast Series

- UK FinReg Focus Areas in 2025: Wholesale Markets
  - We discuss what will likely appear on the reform agenda for wholesale markets in 2025, examining capital markets reforms, changes to the remuneration rules and SMCR, and ongoing work on repealing and restating MiFID II. Available to listen here.
- UK FinReg Focus Areas in 2025: Retail Markets
  - We discuss the key developing areas for retail markets in 2025, breaking down the difficult challenge of balancing risk-taking and growth with consumer protection, discussing what is next for the Consumer Duty, and tracking progress on reforms to the consumer credit and consumer investment regimes. Available to listen here.
- UK FinReg Focus Areas in 2025: Sectoral Trends
  - We discuss the key cross-sector trends for financial services firms in 2025, providing our thoughts on what firms need to be thinking about in relation to the use of AI, the continuing importance of ESG, and the regulatory focus on operational resilience. Available to listen here.

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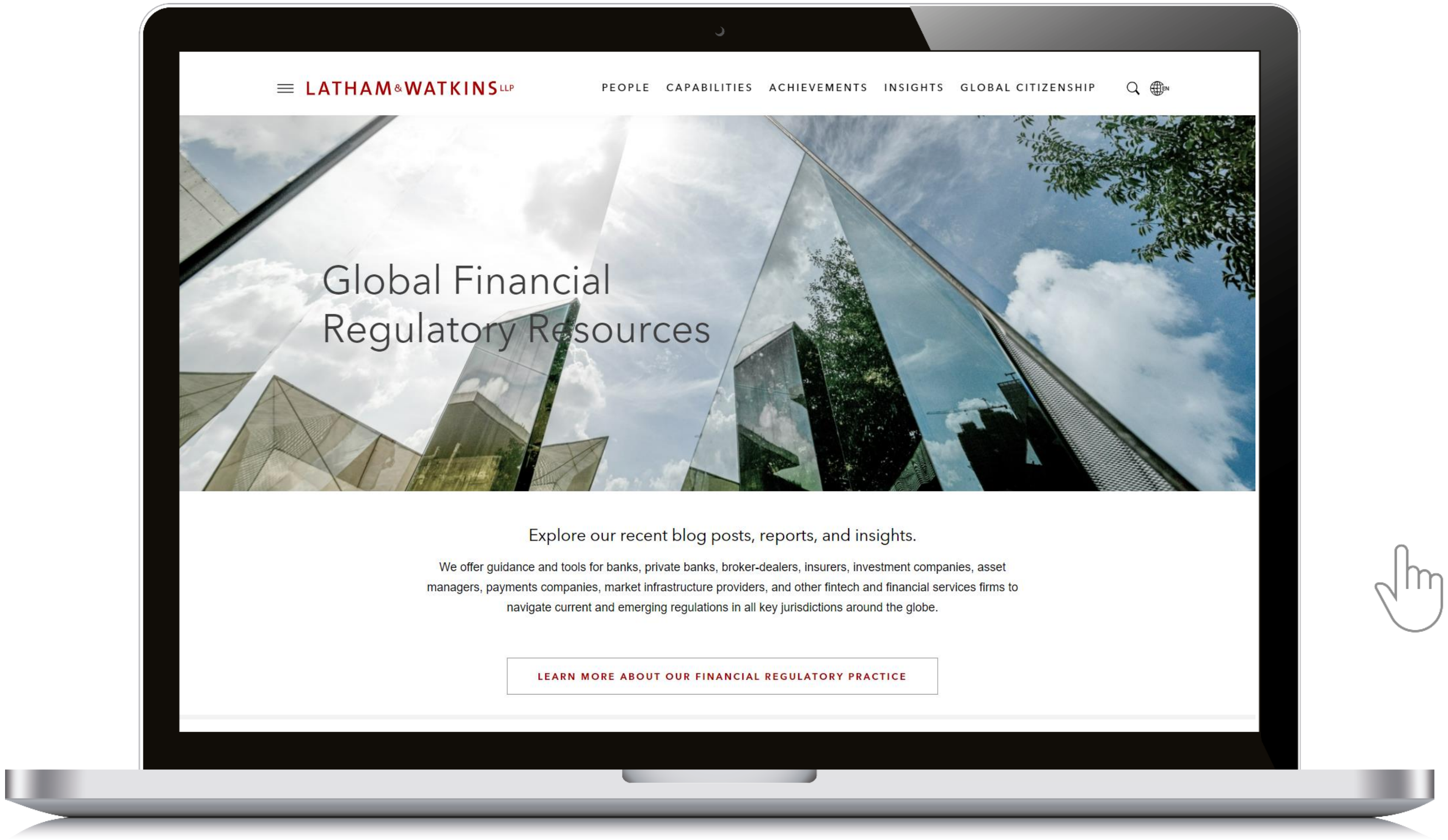

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