

The background of the image is a complex financial market visualization. It features a dark blue and black background with various data series. There are several candlestick charts in green and red, overlaid with multiple line graphs in shades of blue, cyan, and red. Some lines are solid, while others are dashed. The overall aesthetic is high-tech and data-driven, typical of a financial or regulatory context.

Financial Regulation Monthly Breakfast Webcast

16 October 2024

LATHAM & WATKINS

Today's Topics

The FCA's latest Consumer Duty feedback, focusing on price and value	Becky Critchley
An update on the status and impact of the EU AI Act	Elisabetta Righini
The recent FCA fine against a challenger bank for financial crime failings	Jonathan Ritson-Candler
A round-up of expected UK policy work over the coming months	Rob Moulton





The FCA's latest Consumer Duty
feedback, focusing on price and
value

Becky Critchley

FCA Price and Value Outcome: Good and Poor Practice update

- 18 September 2024 update from the FCA with guidance on price and value outcome
- Useful insights and examples of what the FCA considers to be good and poor practice

“Our rules do not set prices, require prices to be low, or require firms to charge the same as competitors”

FCA key messages

- The FCA sets out five key messages for firms to consider in light of its feedback:
 1. Firms should take care not to consider the price and value outcome in isolation
 - Products and services which do not meet other aspects of the Consumer Duty are unlikely to offer fair value to that customer, whatever the price
 2. Firms that have effectively identified target markets at a sufficiently granular level will find it easier to assess impacts on different customers
 - Which customers likely to get value from the product?
 - Which customers are less likely to get value?
 - Are outcomes for different groups of customers in the target market considered?
 - Separate FVA for products or services with significantly different features or target markets
 3. Firms need to be conscious of the impact of cross-subsidies, particularly on vulnerable customers

FCA key messages (cont.)

- The FCA sets out five key messages for firms to consider in light of its feedback:
 4. Evidence used to support assertions made in fair value assessments should be proportionate to the size of the firm and complexity of the assessment
 - Assessments must be backed by “reasonable” evidence
 5. Prompt action should be taken if fair value assessments show customers are at risk of not receiving fair value, and firms must monitor the results of any such action
 - Root causes analysis
 - Specific mitigating actions to take
 - Monitoring of their impact and success
 - Important MI

Proportionality

- FCA does not expect smaller firms to apply the same resources to assessing fair value as larger firms. These firms can take a reasonable and proportionate approach in light of:
 - Their resources;
 - Size of client base; and
 - The complexity of the factors being considered in the fair value assessment



Part of the FCA update on cash savings market

- 18 September 2024 FCA update on its wider cash savings market work
- Relevant to all firms that hold cash and retain or pay interest



TSB fine

- TSB fined £10.9 million by the FCA for its treatment of customers in financial difficulty
- TSB found to have treated almost 233,000 customers unfairly between 2014 and 2020, and has since paid £99.9 million in redress
- **Customer circumstances:** “the staff member queried items of expenditure within the I&E Assessment which they removed or reduced to allow an arrangement to be set. This included removing £20 per month allocated for children’s clothes (including a school uniform that was being paid off in instalments) and removing a buffer of £50 per month for emergency expenditure, which the customer said they could not afford. The staff member also asked the customer to consider making sandwiches for their son instead of paying for school meals, which the customer refused. As a result of the reduced expenditure, the I&E assessment showed an unrealistic surplus of funds”

TSB fine (cont.)

- **Forbearance:** “unaffordable arrangements were set, and the customer was pressured to make a payment to access further forbearance options”, “the staff member pressured the customer to make payment without checking affordability, and also inappropriately asked whether the customer could borrow money from family or friends to pay the arrears balance”
- **Vulnerability:** “Application of arrears fees to customers who were vulnerable, including a customer living in a care home after an Alzheimer’s diagnosis and another who was unable to work due to caring responsibilities and whose partner was also finding it difficult to maintain a job as a result of injury. Arrears fees were applied to a mortgage in a deceased customer’s sole name where there was no grant of probate or personal representative in place, meaning that there was no prospect of repayment activity taking place on the account at that time”

TSB fine (cont.)

- **Bank errors:** “TSB applied a large payment as a debit rather than a credit to the account and wrongly applied subsequent corrections. The errors brought the account over the threshold for litigation, which TSB commenced improperly”
- Pre-dates the Consumer Duty but learnings are relevant under the Duty, particularly regarding the approach to vulnerable customers

“It’s good to be different”: the new FCA supervisory strategy for the financial advice sector

- Consultation Papers on advice guidance boundary review covering:
 - Pensions
 - Retail investments
- Call for firms to innovate and take risks
- M&A
 - FCA area of focus
 - Importance of good governance and focus on customer outcomes
 - Clear Board level ownership and evidence of robust due diligence, to ensure good client outcomes are achieved: *“...who wears the client hat in signing off a deal and implementation plan”*



An update on the status and impact of the EU AI Act

Elisabetta Righini

EU AI Act: Navigating a Brave New World

- It establishes the world's first comprehensive regulatory framework for AI
- It is expected to shape the future of AI regulation and governance both within and beyond the EU
- Its text counts 50,000 words, 180 recitals, 113 Articles and 13 annexes
- It entered into force on 2 August 2024
- It regulates the trustworthiness of AI systems placed on the EU market



Timeline for implementation

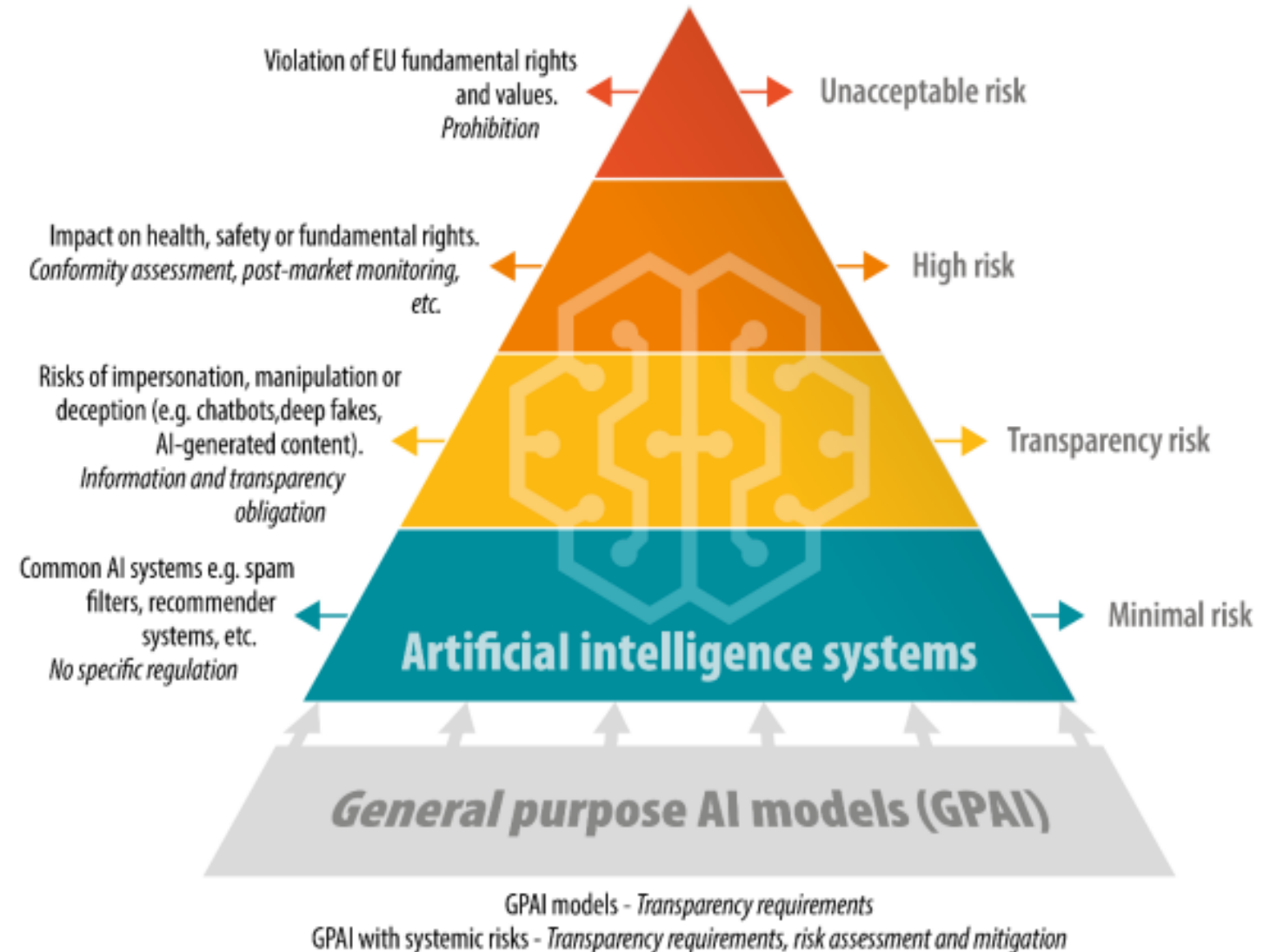
- Its milestones are as follows:
 - 2 February 2025: Prohibited AI practices must be withdrawn from the market
 - 2 May 2025: Codes of practice will be ready
 - 2 August 2025: General purpose AI (GPAI) models must be in compliance. Governance structure (AI Office, European Artificial Intelligence Board, national market surveillance authorities, etc.) will have to be in place
 - 2 February 2026: European Commission to adopt Implementing Act, which lays down detailed provisions that establish a template for the post-market monitoring plan and the list of elements to be included in the plan
 - 2 August 2026: All rules of the AI Act become applicable, including obligations for high-risk systems defined in Annex III (list of high-risk use cases). Member States shall ensure that their competent authorities have established at least one operational AI regulatory sandbox at national level
 - 2 August 2027: Obligations for high-risk systems defined in Annex I (list of EU harmonization legislation) apply

Essentials

- It creates rules for the whole value-chain of AI Systems:
 - **Provider** = develops and supplies the AI System/GPAI model for use in the EU, Art. 3(3), (10)
 - Responsible for creating/maintaining a safe AI System
 - E.g., provider of an AI powered SaaS HR system
 - **Deployer** = uses the AI System/GPAI model in a professional capacity, Art. 3(4)
 - Responsible for safely using an AI System
 - E.g., company using a SaaS HR system
 - Supporting actors/roles (selection):
 - Product **manufacturer** = includes an AI System in its products, e.g., Art. 2(1)(e)
 - **Importer** = supplies an AI System of an ex-EU provider in the EU, Art. 2(1)(6)
 - **Distributor** = supplies an AI System in the EU, Art. 3(7), without being a provider or importer
 - Other “parties in the value chain” = tooling, model training, testing, integration, etc., Recital 88

Essentials (cont.)

- AI Systems are divided into four risk categories (→ and corresponding obligations)
- Foundation models (GPAIs) have special rules
- Administrative fines (not criminal) up to 7% of global revenues
- Excluded from the Act: scientific research, much commercial R&D, some open source, military, defence or national security



Which products are covered?

- **AI System**

- “[M]achine-based system designed to operate with varying levels of **autonomy** ...[that] **infers**, from the input it receives, how to generate ... predictions, content, recommendations, or decisions.” Art. 3(1)
 - Yes: Autopilot, chatbot, AI tutor, facial recognition system, etc.
 - No: Statistical analysis software, physics simulation, etc.

- **General Purpose AI Model (GPAI)**

- “AI model ... that displays significant **generality** and is capable of competently performing a **wide range of distinct tasks** ... and that can be integrated into a variety of downstream systems or applications” Art. 2(63)
 - Yes: LLM, generative image/video model, etc.
 - No: Cancer cell image classifier, classic expert system, outlier detection, etc.

Which products are covered? (cont.)

Certainly

State of the art chatbot/LLM. Car with state-of-the-art autopilot.

Call center app that directs callers by tone of voice.

Doorbell with facial recognition.

Depends on implementation*

Visual cancer cell recognition system.

Statistical analysis software package.

Forklift collision avoidance system.

Smart home thermostat.

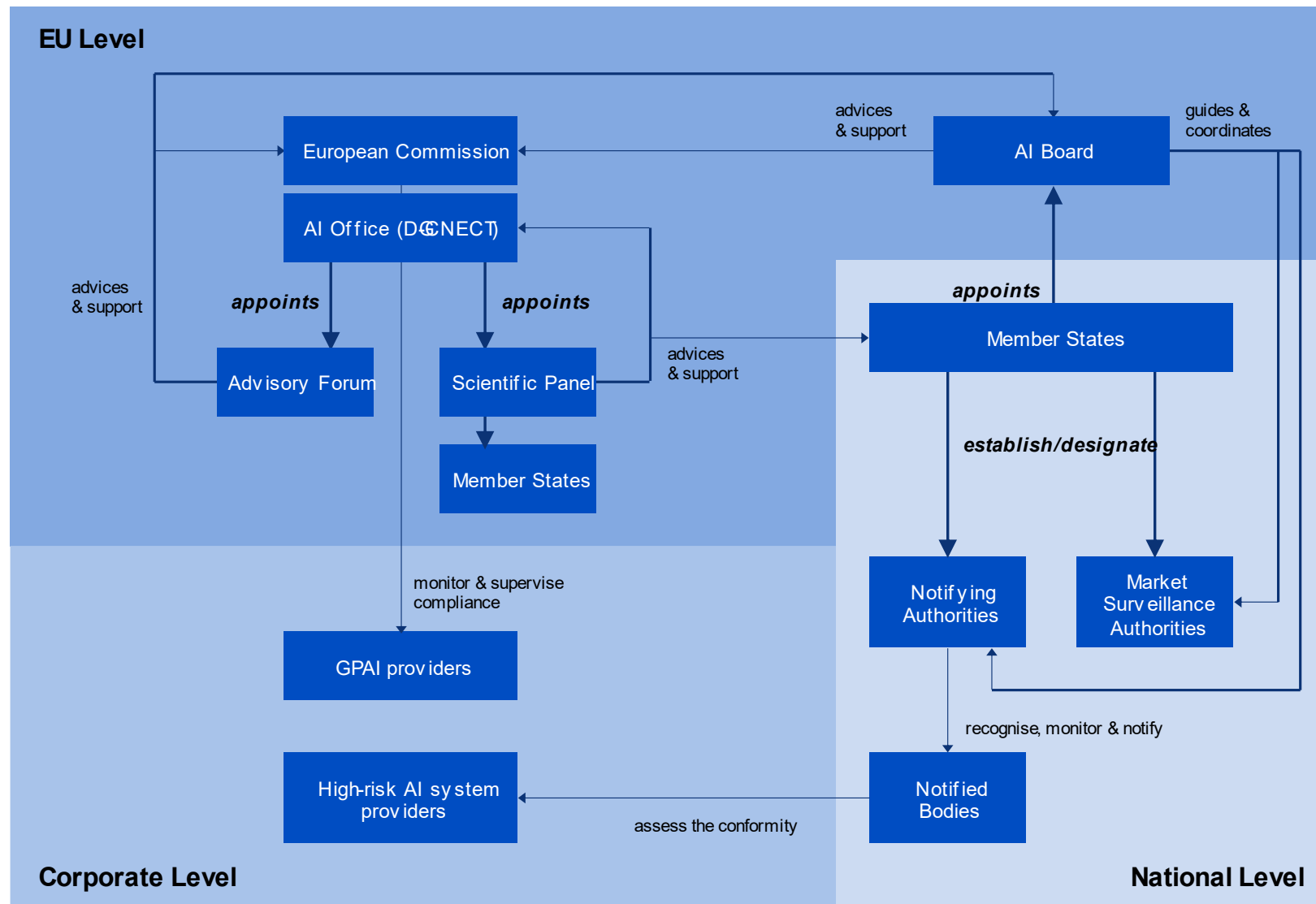
Territorial scope

- The Act applies to AI Systems that are used in the EU
- Providers and deployers may be “established” or “located” in the EU or in a third country:
 - Very low bar
 - No “legal incorporation” required
 - Any presence in the EU, i.e. a bunch of software developers in a garage in Lithuania
 - As long as the AI systems or their output are “for use in the EU”
- Rationale is protecting EU users/consumers

Territorial scope (cont.)

- Europe is not where AI is developed, so why regulate it there?
 - EU Digital Sovereignty – Brussels Effect
- EU's approach to artificial intelligence centres on:
 - Boosting EU research and industrial capacity to fill the gap
 - Ensuring safety and fundamental rights, aka “human centric and trustworthy AI”
- The Act is a harmonizing EU Regulation
 - It occupies the regulatory space at EU level and pre-empts Member States from enacting their own AI rules
 - EU citizen/company will be able to rely on it in front of the courts of the 27 Member States for violations [and damages]

Who is responsible for implementation?



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The recent FCA fine against a challenger bank for financial crime failings

Jonathan Ritson-Candler

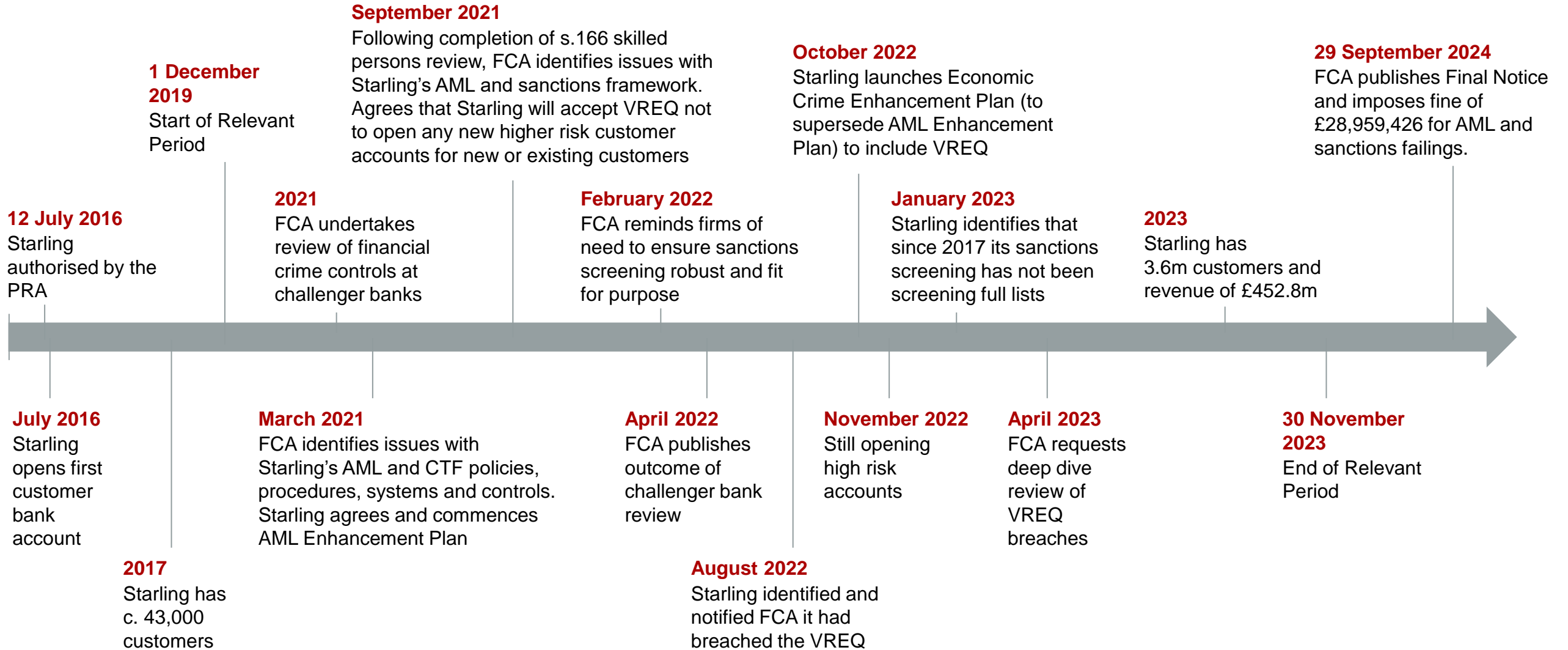
Starling Bank fined £28.9m for AML and sanctions failings

- On 27 September 2024, the FCA published its Final Notice setting out Starling Bank's AML and sanctions screening failings during the period 1 December 2019 to 30 November 2023 (the Relevant Period) and fining it £28,959,426
- Starling was cooperative with the FCA and enhanced its AML and sanctions systems, controls and resources, resulting in a 30% discount to the fine (which would have been £40,959,246)
- The issues arose because Starling is a rapidly growing challenger bank whose resources did not keep pace with that growth or the AML and sanctions risk to which the business was subject

Starling Bank fined £28.9m for AML and sanctions failings

- Two key categories of issues:
 - Identified but unresolved issues with onboarding clients and applying the requisite controls (including enhanced due diligence and ongoing monitoring) for higher risk clients
 - This resulted in the FCA requiring Starling to accept a Voluntary Requirement (VREQ) to its licence, preventing it from opening new accounts for higher risk clients (whether accepting new clients or opening new accounts for existing clients)
 - Starling did not comply with the VREQ
 - Failure to undertake comprehensive sanctions screening

Timeline of events



VREQ and high risk clients

- In September 2021, as a result of a skilled persons review which identified weaknesses in Starling's CDD and client onboarding, the FCA requested it accept a VREQ
- The VREQ required that Starling did not accept or process any new or additional account applications from new or existing customers that are high risk (per the MLRs 2017) or which otherwise present a higher AML or CTF risk
- Starling introduced a series of controls in order to comply with the VREQ, but in July 2022 identified that they weren't working as intended. It then informed the FCA in August 2022 of the issue and that it had instructed its 2LOD to undertake a review
- By November 2022, the 2LOD had identified that accounts in contravention of the VREQ were continuing to be opened, demonstrating that the systems and controls attempting to comply with the VREQ were not fit for purpose

VREQ and high risk clients (cont.)

- On 31 March 2023, the FCA requested that Starling engage an outside consultancy firm to undertake a review of its AML and sanctions compliance framework
- 21 September 2023, the consultancy firm published its report to Starling, citing several failings
- The senior management team as a whole lacked the experience to effectively implement the VREQ
 - Lacked AML skills or experience
 - Had not previously dealt with material regulatory change projects
- Senior management and three lines of defence failed to adequately oversee and monitor day-to-day compliance with the VREQ
- The VREQ was not communicated effectively internally
 - For example, the 3LOD was not made aware of the VREQ until “late 2022” (c.1 year post its implementation)

VREQ and high risk clients (cont.)

- On 26 September 2023, Starling accepted all findings and committed to correcting the failings
- Between 17 September 2021 and 27 September 2024, Starling created 54,359 accounts for 49,183 high or higher risk customers in breach of the VREQ
- Daily automated VREQ controls and alerts went live in January 2023 and were fully implemented by 31 May 2023 which did result in a significant decrease in accounts being opened
- In April 2024, Starling reported to the FCA that for the first month since the VREQ, no high or higher risk clients onboarded / accounts opened in contravention of the VREQ

Sanctions screening

- FCA acknowledges that whilst it is not responsible for enforcing UK financial sanctions, its role is to ensure that regulated firms have adequate systems and controls to comply with the UK regime
- FCA identified concerns with Starling's screening in March 2021 following its review of challenger banks' AML controls
 - In March 2021 the FCA notified Starling that whilst its internal policies said it screened against EU, UK and US lists, in practice it only screened customers against UK lists
- In January 2023, the 2LOD undertook an end-to-end review of sanctions screening and flagged that between 1 July 2022 and 30 January 2023 no sanctions alerts had been generated
 - This was caused by an issue with the system's configuration such that during that period customers were not being effectively scanned against even the UK list
 - On undertaking a root cause analysis, this issue had originated in July 2017
 - Starling identified that during the Relevant Period, at least one designated (sanctioned) individual on the UK OFSI list had opened an account

Sanctions screening (cont.)

- Starling corrected the issue in February 2023 and recommenced live screening
- It also commenced a back book screening review of current, active customers (c. 3.5m)
- This generated c. 48,000 alerts
- Various other failings were identified including:
 - Starling was only screening customers after they were onboarded
 - It was only screening customers every 14 days
 - Sanctions policies required material enhancements
 - No internal guide as to what sanctions alert meant and how to deal with them
 - No formal methodology for calibrating and testing sanctions controls
 - No operational MI (e.g., alert volumes, trends) feeding up the chain on sanctions
 - Starling was not screening cross border payments against the UK list (only domestic payments)
 - When screening domestic payments, it was using a customer screening tool, not a transaction screening tool

Market Watch 80

- SYSC 6.1.1 requires firms to establish implement and maintain adequate policies and procedures to ensure compliance with firms' obligations, including countering the risk that they're used for financial crime
- The FCA uses MW80 to flag a specific example of potentially anonymised ultimate beneficial owners (UBOs) in aggregate trading accounts run by overseas firms – described by the FCA as obfuscated overseas aggregated accounts (OOAAs)

Market Watch 80 (cont.)

- The FCA is concerned that OOAs enable UBOs to commit trades amounting to market abuse but without the UK firms executing the trades having visibility of those UBOs and their activity (and, in these circumstances, UK firms which have previously terminated named accounts of these individual UBOs can unknowingly continue to execute trades for them through OOAs)

Example: 'Client C' has an account with FCA authorised firm 'X Ltd'. In a short period, Client C trades very suspiciously on several occasions, ahead of news events. X Ltd submits Suspicious Transaction and Order Reports (STORs) on each of these occasions, then concludes that Client C exceeds its risk tolerance for financial crime through market abuse and terminates the relationship. Client C then opens a trading account with overseas broker 'O Group'. When Client C submits trades, O Group anonymises them and executes them with FCA authorised firms, including X Ltd. X Ltd is unaware that it is executing trades for Client C, whose relationship it has previously terminated.

Market Watch 80 (cont.)

- FCA therefore recommends firms to consider:
 - Informing OOAs that they operate a zero tolerance approach to market abuse
 - Requiring OOAs, which execute trades for anonymised UBOs, to provide the firm with information about their systems and controls
 - Market abuse surveillance
 - Nature of underlying clients
 - Number of high risk clients
 - Confirm that OOAs will provide a UBO's identity information if the firm is concerned about specific trades
 - Ask OOAs to differentiate between UBOs with sub-accounts carrying unique identifier codes
 - Apply robust measures to end entire OOA relationships where appropriate



A round-up of expected UK policy
work over the coming months

Rob Moulton

Upcoming UK policy work

- PRIIPS/CCI – FCA consultation due Q4 2024; regime expected to be in place H1 2025
- MiFID:
 - Consolidated tape – Tender process to start on CTP for bonds late 2024; FCA to update on CTP for equities by the end of 2024
 - Non-equities – Policy Statement on transparency reforms due Q4 2024
 - Transaction reporting – Discussion Paper due Q4 2024, followed by consultation H1 2025
 - MiFID Org Reg – Consultation due Q4 2024
- Accelerated Settlement – Technical Group to publish final recommendations in December 2024
- Remuneration – PRA/FCA consultation on making the regime “more effective and proportionate” expected Q4 2024
- Operational resilience – PRA/FCA/Bank of England to finalise policy framework for Critical Third Parties, and publish Consultation Paper on operational incident reporting, in Q4 2024

Upcoming UK policy work (cont.)

- Non-financial misconduct – FCA to publish results of survey “shortly” and finalise new guidance by the end of 2024; FCA/PRA Policy Statements on wider D&I proposals expected in 2025
- Vulnerable customers – FCA to publish results from its review of firms’ treatment of customers in vulnerable circumstances in Q1 2025
- Consumer Duty – FCA to publish outcome of its Call for Input reviewing retail conduct requirements in light of the Consumer Duty in Q1 2025
- Advice Guidance Boundary Review – FCA consultation on pensions expected Q4 2024, with a consultation on retail investments in 2025
- SDR – FCA to publish final rules on SDR for portfolio managers Q2 2025
- ESG ratings – HM Treasury to publish consultation response by the end of 2024
- Enforcement – FCA to publish further information on its proposals to announce enforcement investigations in Q4 2024, aiming to reach a final policy decision in Q1 2025

Upcoming UK policy work (cont.)

- Key work for which dates remain uncertain:
 - SMCR – Consultation Paper on potential improvements and reforms to the SMCR
 - Bank ring-fencing – Government to set out proposals for long-term reform of the bank ring-fencing regime
 - Consumer credit – Second stage consultation on reforming the Consumer Credit Act 1974
 - Short Selling – FCA to consult on new rules for the regime



FCA whistleblowing incident

- FCA published the results of a senior independent director review into the handling of whistleblowing communications by the Chair of the FCA, Ashley Alder
- Concerns raised by two individuals (former FCA employees) about the handling of their whistleblowing communications by Mr Alder
- The report found:
 - Although Mr Alder had not followed the FCA policy to the letter, he had acted reasonably
 - Mr Alder reasonably believed he was forwarding the communications to individuals who already knew about the matters, and on the understanding they were generally required to operate under strict terms of confidentiality
 - Mr Alder acted in the firm belief that there was no realistic prospect of causing harm to the whistleblowers
- FCA plans to make certain changes to its internal whistleblowing policy
- **How would the FCA treat an individual at a regulated firm in the same scenario?**

Recent Thought Leadership

- [FCA Publishes Further Consumer Duty Feedback](#)
- [FCA Publishes Update on Cash Savings Work](#)
- [EU AI Act: Navigating a Brave New World](#)
- [EU AI Act: Obligations for Deployers of High-Risk AI Systems](#)



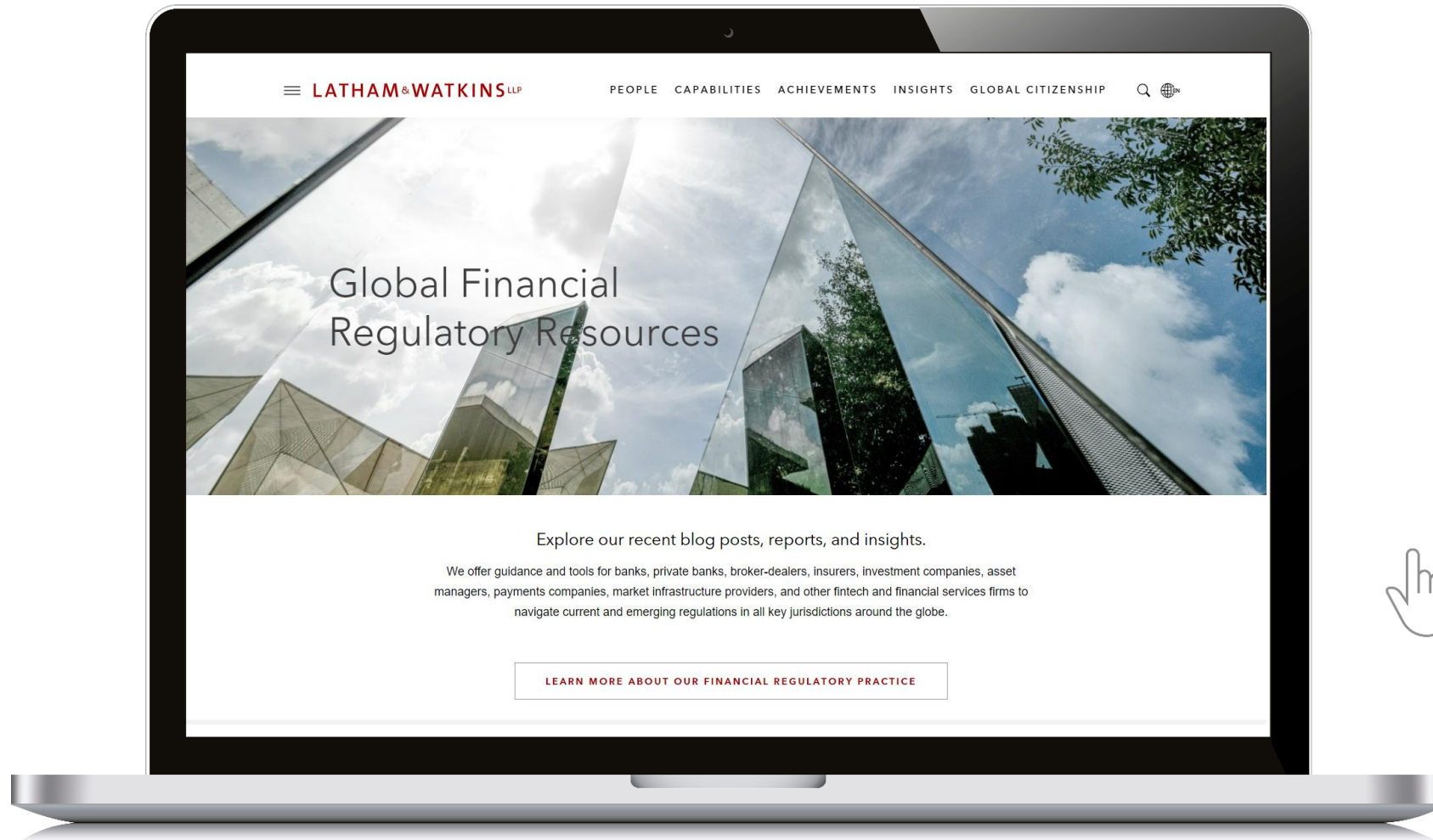
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