

Advantage

NAVIGANT REGULATORY UPDATE
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 NAVIGANT

Welcome



Peter Brooke
Director
Ph: +44 (0)207 015 8750
peter.brooke@navigant.com

Welcome to the Autumn Edition of Navigant's Advantage Regulatory Update where we'll try our best to arm you with the practical knowledge you'll need to keep on the straight and narrow, and avoid the long arm of the FSA.

In this issue we explore the implications of divergent audit and legal opinions for CASS Client Money policies – Karen Bond asks who should you trust, and invites you to our Client Money workshop at the Navigant office next to the Guildhall, just prior to the nearby TISA Conference on Wednesday 16th November.

Don't fancy a trip to prison? Read our feature on the Bribery Act which is already in force and could trigger some harsh financial penalties for your firm, and the risk of a 10 year prison sentence for non-compliance.

Finally, we explore the Fact or Fiction of the US Foreign Account Tax Compliance Act, better known as FATCA, which could require UK firms to withhold up to 30% of the proceeds from sales made by clients; if you're not adequately prepared, you could have some very irate customers on your hands, or worse, a censure from the IRS. We set out how to negotiate the legislation, and boil this complex legislation down to its more digestible constituent parts.

We hope you enjoy this edition of Advantage. Please contact Peter Brooke or Karen Bond for additional information related to this newsletter.

Client Money – Who Do You Trust?

Achieving a clean audit or FSA report on the operation of your CASS processes has never been particularly easy. Fines in the tens of millions have been imposed for Client Money failings and the FSA's establishment of a speciality CASS team clearly demonstrates their continued interest in this area of the rules.

Feedback from the FSA has made it very clear that they are not satisfied with the results from ARROW visits as to how firms are controlling Client Money and Assets. As a consequence s166 reviews are becoming relatively commonplace. Now, however, there are additional complexities around the fact that some auditors have been referred to the Auditing Standards Board as a consequence of the FSA identifying subsequent breaches in firms which had not been picked up by these reviews.

So if there is some doubt as to the reliability of auditor opinions, where do you turn?

Many have looked to lawyers for their opinion, particularly when faced with situations that are hard to interpret in the context of the current, broad based rules. Those who have worked in Operations will be familiar with the response of "it depends" as the specific circumstances of a scenario often lead to grey areas and hence the need for opinions. Here, too, there are risks. Post Lehman's, there are case law decisions that are not yet reflected in the FSA rulebook. Unless or until such changes are made, it is unclear what the FSA might do if faced with a firm which has relied on case law that is not aligned with the current rules.

Before that, however, there is a risk that the opinion itself may be correct but may be based on incorrect assumptions about the circumstances involved. If clarity about the specifics of the process is lacking, the opinion could be completely right but completely inapplicable for the required situation, or alternatively only applies in some circumstances but not all.

The application of the rules also, often, requires a detailed understanding of the practicalities of the day to day processes in the business. For example, the timings of switch transactions can have a material impact on the daily funding requirements. Does the lawyer have this level of analysis available, or how the process may change if for example prices were delayed, to inform their decision?

We have seen numerous examples when the advice given to firms has resulted in a position which is, at best, unexpected and sometimes contradicts Principle 10. The overarching question which the FSA may want the firm to ask, however, is whether the action or process they are contemplating is fair to the client? Does it provide the protection that the client would reasonably expect to receive? By focusing on the letter of the law it can be too easy to lose track of the principles.



Karen Bond
Director
Ph: +44 (0)207 015 8750
karen.bond@navigant.com

The interaction with the overarching principles, such as Treating Customers Fairly, can be informative. For example, those holding funds in relation to large volumes of unrepresented cheques may consider this in the context of deciding how much effort to make to contact 'gone away' clients.

If auditors and lawyers can interpret the rules "incorrectly", it makes it difficult to determine with certainty whether your firm is in line with FSA requirements. If all these questions tell us anything, they confirm that 'it's complicated'.

If you'd like to understand how best to interpret the minefield of CASS legislation, contact karen.bond@navigant.com or call 0207 015 8750

Event

If you'd like to learn more about how your fellow firms are addressing Client Money matters, Navigant is hosting a workshop on our recent market experiences and practical applications of the rules on the morning of Wednesday 16th November. [Click here for more information.](#)

If you'd like to join us, please contact Lois Saville on 0207 015 8718, or if you'd like to discuss the complexities being faced by your firm, please speak to Karen Bond or Mark Lester on 0207 015 8750. Invitations will be on a first come first serve basis.



Bribery Act and its Implications on Financial Services

Fail to prepare – prepare to be punished!

The Bribery Act 2010 contains serious penalties, including unlimited fines for firms and individuals and prison sentences of up to 10 years. Any breach would, of course, be seriously damaging to your firm's reputation. In this article we look at some of the requirements and their practical impacts for financial services firms.

Why prepare?

Some believe the Act will not significantly affect those in Financial Services. They consider it a sword more likely to be drawn over industries such as construction or defence, expecting it to make headlines in relation to MPs or bodies such as FIFA.

In fact, the FSA recently fined Willis £6.9 million for anti-bribery and corruption systems and controls failings. In this case, there was no proof that bribery occurred – simply that the controls required were not in place.

The FSA has introduced a section on 'Combating Bribery and Corruption' in their recent guide on Financial Crime for firms. This is a clear indication the FSA will be looking at this as a high risk area for the industry. If firms fail to prepare and adapt, they will soon be joining the likes of Willis in being scrutinised, investigated and disciplined by the FSA and Serious Fraud Office.

What is the Act?

Under the Act there are four main offences:

1. Offering, promising or giving a bribe (active bribery)
2. Requesting, agreeing to receive or accepting a bribe (passive bribery)
3. Bribing a foreign public official
4. Failure of a commercial organisation to prevent bribery

How to Avoid Punishment: Prepare!

Firms are under a regulatory obligation to put in place systems and controls to mitigate corruption risk and to conduct their business with integrity. By following the six principles, firms can ensure they do not fall foul and hear the loud knock of the FSA at their door.



Peter Brooke

Director

Ph: +44 (0)207 015 8750

peter.brooke@navigant.com

Risk Assessment

Organisations must conduct a comprehensive review and assessment of the potential bribery and corruption risks associated with their products and services, customers, third party business partners and geographic locations. This means identifying potential areas of risk, reviewing procedures and taking action where necessary.

Top Level Commitment

Educate the board of directors and management to ensure clear and strong messages and materials are in place to confirm that bribery and corruption is unacceptable and will not be tolerated.

Due Diligence

Organisations must develop and document a due diligence protocol that assesses and addresses the potential bribery and corruption risks, focusing on:

- i. Geographic risk;
- ii. The risks associated with a specific opportunity or transaction; and
- iii. The reputational, legal and regulatory background of the individuals or entities involved.

Doing so enables firms to focus resources on the highest risk areas of the business.

Clear, Practical and Accessible Policies and Procedures

The three aspects to this principle include:

- i. Policy and Procedure Documentation;
- ii. Support and Operational Procedures; and
- iii. Incident Management.

Effective Implementation

Effective implementation includes imposing responsibilities for implementation and a timeline, including a plan for communicating the availability of education and training coupled with a clear statement of penalties for non-compliance. The FSA would also expect to see a plan for assessing and monitoring compliance and to the extent necessary, revising or enhancing the compliance program.

Monitoring and Review

The compliance procedures should include mechanisms to monitor and review the operation and effectiveness of the compliance program.

The Act came into force on 1 July 2011, following publication of the Guidance on the interpretation and use of the Act by the Ministry of Justice in March 2011. To avoid the spectre of fines or more serious intervention, it is essential that your firm has a policy in place to address this new legislation.

For further information on the Bribery Act, please contact peter.brooke@navigant.com or call 020 7015 8750

FATCA – Fact or Fiction?



Jason Whyte
Director
Ph: +44 (0)207 015 8750
jason.whyte@navigant.com

Imagine for a moment that you hold 100 Berkshire Hathaway A Shares on behalf of your clients, and you sell them back to Warren Buffet at \$120,000 each as part of his proposed buy-back, netting a cool \$12m.

Except that when the settlement arrives, you find that your US custodian has withheld 30% of the proceeds. Even worse, you realise that your terms and conditions require that you have to make good that amount to your clients. Even though you think you can eventually claw most of the money back through a tax reclaim, you'll be out of pocket by \$3.6m for quite some time.

The next time you sell a US holding, it happens again. And the non-US financial institutions that you deal with start doing the same thing.

Welcome to life under FATCA

The US Foreign Account Tax Compliance Act is a long, dry and convoluted read. Many UK financial institutions tell us they are only just getting to grips with it. And yet the nightmarish scenario above is an all-too-possible outcome of failing to prepare properly for a change that Navigant believes will affect every player in the sector.

Managing Impacts

Fortunately, most of the impacts of FATCA can be managed with the right preparation. This article seeks to take some of the mystery out of FATCA and separate the Fact from the Fiction. In particular, it aims to explain why we believe that, as a Foreign Financial Institution or FFI, it is critically important to get classified as a "Participating" firm.

FATCA's purpose is to identify US persons who use offshore accounts and funds to evade US tax obligations. Its goal is to raise money for the US Treasury. The US has already obtained agreement from an international bank to pay \$780m in fines for maintaining undeclared offshore accounts for US taxpayers.

Some commentators have stated that complying with FATCA would be illegal due to UK and EU Data Protection legislation. This is possible; however it would be a major mistake to think that this will stop the Act being effective. The pressure the IRS can exert on the whole financial systems through US companies is enough that we expect people to find a way to comply.

The withholding tax described above will phase in from 1 January 2014, starting with withholding on interest and dividends; to avoid its impact, organisations will need to reach agree-

ment with the Internal Revenue Service (IRS) and have processes in place in H2 2013. If successful, other countries are likely to use similar legislation both to raise money and also as a political tool. It is seen as a good thing to be hard on tax evaders; we have already seen the once fortress-like, secretive Swiss banks begin to provide tax payments and data to external tax authorities.

FATCA broadens this to ask all financial institutions to provide data to the IRS on income and sale proceeds originating from the US that are made to 'US persons', the definition of which includes more than just US citizens.

Under FATCA, the IRS will divide the financial world into US Financial Institutions (USFIs), and Foreign Financial Institutions (FFIs), who will be either Participating (PFFI) or Non-Participating (NFFI) depending on whether they have reached an agreement with the IRS to provide the relevant data to the US and to withhold tax under certain circumstances. Organisations will have little to no say about whether they are an FFI – the IRS will decree it – but they need to decide whether to be Participating or not.

USFIs and PFFIs agree to withhold 30% tax on payments of US proceeds to NFFIs and "recalcitrant" persons who have not agreed to release account data to the IRS. Proceeds include not just income and dividends, but also the sale of US assets – as in the Berkshire Hathaway example at the start. The benefit of becoming a PFFI is that USFIs and other PFFIs will not withhold tax on payments to you; the "cost" of becoming a PFFI is negotiating an agreement with the IRS, gathering data and permissions from your clients and withholding the tax yourself.

Organisations may assume that they can safely default to being Non-Participating if they don't have a large US presence, a high volume of US investments or a significant proportion of "US persons" in their customer base. We think this would be a serious mistake.

Passthru Payments

The primary reason for this is the "passthru payments" rule. In order to qualify as Participating, FFIs are required to withhold tax on any payments that they make to Non-Participating FFIs. The exact amount to withhold is based on the average proportion of US assets in the Participating FFI's own asset base over the last 4 quarters – the so-called Passthru Payment Percentage or PPP.

The net impact is that a Participating UK-based fund that had 70% of its assets invested in the US would withhold (or in practice get its custodian to withhold) 21% of any dividend paid to an NFFI.

For those UK managers considering a Non-Participating status, this is a major reason to think again. Why would an introducer or adviser tell a (non-US) client to invest with an NFFI, when the PFFIs they deal with will withhold 30% of any proceeds from the US? Taking this a step further, surely they will be actively advising their clients to move existing investments with NFFIs to FFIs following a similar strategy. Unless an FFI is certain that both its own funds and the other FFIs it invests in all have, and will continue to have, minimal US holdings, becoming a Participating FFI is the only viable option.

With its heavy layer of tax regulation (much of which is yet to be finalised) FATCA is seen as a daunting and complex challenge by many. Our view, however, is that this is basically a large data manipulation exercise with a relatively small regulatory component. It requires PFFIs to initially identify 'US persons', or potential 'US persons' and not tax. Once the 'US persons' have been identified, information on these individuals will need to be passed to the IRS. Where the data is not available or not disclosed, the PFFI is required to withhold a flat 30% tax on US proceeds, or a passthru tax based on a published PPP. In an ideal world where a company has a single system with all the data accurate and easily accessible, this may be fairly straightforward.

More common is where companies have data on multiple systems, some in-house and others outsourced. Historically, there was often no reason to check the accuracy of all of the data, resulting in the data in some fields being questionable as the individual fields were not designed to be interrogated, as they will now need to be. Examples of the data now required to be checked are those with addresses such as C/O and/or PO Box as well as country codes.

Having identified all existing 'US persons', PFFIs will need to update their systems to identify any new investors that are of interest to the IRS. Finally, PFFIs will be required to put in place processes and procedures to withhold and pay over the relevant amounts of tax.

Further clarity on the rules is expected over the next two years with the next tranche due in December 2011, but this does not mean that managers can wait until the final rules are known; there is plenty that can be done now.

Reporting Challenge

One challenging aspect of FATCA is the identification of those clients for whom reporting may be required. Many companies will require an analysis of tens of thousands of accounts on transfer agency, wealth management, life assurance and a multitude of other systems. Although much of this may be performed electronically, to identify possible problem ac-

counts, significant additional work will then be essential on the accounts which require further checking.

However, the most difficult aspect of FATCA implementation may turn out to be how to handle clients once they have been identified. Companies will need to notify clients and get their consent to supply data to the IRS (if local laws permit) and decide what to do with "recalcitrant" clients.

It's also likely that existing terms and conditions do not make adequate provision for FATCA. Companies may need to agree terms with their clients that permit them to withhold tax and make it the client's problem to recover it – or face having to refund the withholding.

Simply put, FATCA requires firms to set up and manage a large data manipulation project while in parallel working through the detail of the legal and regulatory implications with the IRS, local authorities and clients. If you do not start soon, you or your clients may suffer a 30% withholding tax on sale proceeds and income, not just on US funds but also on firms with US interests and hence income. Failure to be ready for FATCA could put your firm at a severe disadvantage to your competitors, many of whom have already started FATCA projects.

If you'd like to know more about separating fact from fiction, contact jason.whyte@navigant.com or call 0207 015 8750



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