Jersey Financial Services Commission

STEP Jersey's 23rd Annual International Conference
Speech by John Everett, Director of Funds and Fiduciary

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Good afternoon. Thank you, Lorraine, for that introduction.

The four areas I want to cover today are:

- our supervisory work and findings;
- change and consolidation in the trust industry;
- a review of the Commission's wider work to date in 2015; and
- change at the Commission itself.

Hopefully there will be some time for questions as well, but we'll press on as I know I'm all that's standing between you and lunch!

So, turning first to trust industry supervision, it's very important to note that every day, trust company businesses in Jersey are providing value-added compliant services to their client base. As the regulator, we get involved when things haven't gone so well, and so my comments today about some of the things we have seen represent the small number of cases where problems have arisen.

I would ask that you reflect on the circumstances I mention and whether there is room for improvement in the businesses you work in. As with all constructive feedback, the intention is that positive changes result.

As you probably know, the Commission undertakes an intensive visit programme throughout the year, backed up by an annual data collection exercise; in addition to using intelligence received and information on wider trends. We are not an 'enforcement led' regulator and where possible try to work with firms to remediate deficiencies through a 'post examination monitoring schedule' - with the proviso that in some instances, the seriousness of a case, or the attitude of a firm towards regulatory improvement is such that enforcement action needs to be considered. Some of the findings I am about to discuss have resulted in enforcement cases.

One point I have noticed is that we are receiving an increasing amount of regulatory intelligence from 'whistleblowers'. Often this information is specific, actionable and material, and so of key interest to the regulator. I would like to make clear that, where a member of staff leaves a firm by way of settlement agreement, such arrangements should not seek to prevent either the firm or the individual concerned from speaking to the regulator, about the circumstances of their departure or indeed any other matter.

I'm going to feedback briefly on some of the findings from our 2014 and 2015 visit programmes to date, starting with AML/CFT issues. Of course AML/CFT findings will always

be a key area of interest for supervision and I would reiterate that these are based on individual cases rather than industry-wide weaknesses.

Regarding suspicious activity reports, we found examples of weak internal procedures, including some that might have resulted in internal reports not reaching the MLRO. Evaluation of internal SARs sometimes appeared to have taken a disproportionate length of time, even where public domain information was available. The evaluation process preceding the decision not to file a SAR was undocumented. In some cases we believed that the MLRO was under-resourced to carry out their role properly.

A key area of day-to-day business relates to customer due diligence. In this area we found weaknesses in the identification and verification of customers – for example, lack of information on file, poor understanding of ownership and control and failure to properly verify information or documents. In some cases, services had been provided before the completion of identification measures.

The identification of, and then – importantly - the response to, risk factors was unclear – for example, regarding initial and ongoing PEP classification and the carrying out of enhanced due diligence. Often this appeared to reflect a lack of understanding, or at least documentation of, the rationale. From time to time the Commission is told on visits, when there is not much written down, that 'Fred knows all about this structure' – which makes us wonder how the business will cope if Fred falls under the proverbial bus…

Regarding enhanced due diligence, it appeared that sometimes 'red flags' did not receive appropriate attention. The sort of factors we think of here include:

- connections to high risk jurisdictions or those subject to sanctions;
- allegations of corruption or an association with financial crime;
- uncertainty regarding the settlor of a structure; and
- lack of information to support the source of funds or title to assets.

In respect of ongoing monitoring, we noted that in some cases automated search criteria and screening parameters had been set too narrowly.

We do think that a firm's Business Risk Assessment is a key tool in the fight against money laundering, but too many documents that we review are still generalised and not reflective of the specific risks facing the individual firm concerned, given its strategy, risk appetite and customer base. Fundamentally, the risks identified through the BRA should then inform the policies and procedures which should serve as mitigating controls to those risks.

Nor is the BRA supposed to be a static exercise, for the document to be put on the shelf and perhaps dusted off when the Commission is due to visit. Some firms had not given due attention as to whether the acquisition of a book of business, or some other type of organisational development, necessitated change to their BRA. Given the amount of corporate activity in the sector, this was a concern.

Regarding corporate governance and wider internal controls, we continue to see some examples of inadequate identification, recording and management of conflicts of interest, which will always be a warning sign for regulators. In some cases Boards or Committees did

not appear to meet with sufficient frequency, or there were unclear reporting lines or deficiencies in meeting CPD requirements. We also saw instances of missing client records, limitations in compliance monitoring programmes and challenges with the resourcing of compliance functions, which I will return to later.

With respect to the increasing use of Treasury operations, we expect to see clear controls for documenting the rationale for placing customer monies with an in-house or group function or other preferred provider, as well as transparency regarding fees. We also noticed some instances of deficient client account reconciliation and lack of escalation of unreconciled items.

Finally, some firms appeared to take an overly narrow approach to what was being handled as a 'complaint'.

I appreciate that was something of a dry list of points without wider context, but perhaps I can just give a couple of examples to bring things more to life. First, a disappointing case. In one entity we visited, we found an issue which the Compliance Officer had recommended be disclosed to the Commission, in line with Principle 6 of the Codes of Practice.

A considerable email round robin had then developed over time among the firm's Directors, which culminated in the decision being taken not to disclose. For me, there are two simple takeaways from this: one, without wanting to sound too glib, if you've spent more than five minutes debating whether something should be disclosed, then it probably should be; and two, if your Compliance Officer says something should be disclosed then you need strong justification not to do so.

On the positive side, and reflecting the Commission's desire to work with firms, we have seen a number of examples this year where firms about whom we have had concerns have entered into visits and dialogue in a spirit of co-operation with the Commission. Sometimes that has coincided with a change at the top of a firm. But a spirit of openness and transparency, unlike my first example, will always be a positive factor in a firm's regulatory relationship.

Litany of woe over! Let's move now from talking about micro-issues within individual firms to my second topic, about the trust industry more widely. One issue that always seems to be raised, with some strongly held views on either side of the debate, is the involvement of private equity ownership. From time-to-time we at the Commission are asked for our 'view' on private equity. Broadly, we are neutral on ownership structures, so long as they promote good governance, risk management and client outcomes. Those desirables do not appear to necessarily conflict with any particular ownership structure, rather it's what happens in practice that matters. Some diversity of ownership structures may also of itself be beneficial.

This year we have seen the flotation on the main market of the London Stock Exchange of one of our fiduciaries. It is notable that since the flotation, and despite some of the severe market volatility we saw in recent months, the share price of the company concerned has increased by almost 50%. This increase in valuation will not have gone unnoticed by current or potential investors in the industry, and I am sure we will see continued interest while viable and profitable exit routes for such investment are available.

Given the strategic importance of the trust industry to the Island, and our Chairman's commitment to the Commission being a 'listening regulator', earlier this year a sub-group of the Commissioners carried out a number of visits to the CEOs and senior management of a selection of entities, as well as JATCO and some referring firms in London, to ask them about their thoughts on trust company business in Jersey currently and in the future.

I also attended these visits, and what struck me was, firstly, the heterogeneous nature of the firm population in the Island, and secondly, that there was a highly positive tone about Jersey's position both now and in the future. The firms involved exhibited a variety of ownership structures and we heard some of those strong views on private equity I just mentioned! These included the benefits of outside investment in designing and putting in place robust systems and control frameworks; while others argued that key referrers valued independent ownership which, it was argued, inherently allowed a longer-term view to be taken.

Regulators generally don't like to engage in speculation, but I don't think I'm being particularly controversial in suggesting that it appears difficult to see any future in which there is not further consolidation within the industry. That is consolidation of firm numbers, incidentally, not necessarily of number of employees.

What may be more interesting is to consider what the shape of the market overall may be like in five years' time. One view would be that inevitably 'small' firms will have disappeared from the picture, by retirement or sale, leaving only a small number of giants. However, I think it is equally possible to foresee a future where the largest firms are accompanied by a set of smaller boutique or niche providers with good margins, leaving a group of firms which might be described as the 'squeezed middle'.

I would reiterate that the regulator's interest is in firms having effective and robust risk management, whatever their size or client focus. What does concern me at the moment are trust companies who are attracted to move into the provision of fund services business, given the growth in that sector, but may be underestimating the complexity and thus expertise needed - and consequently not investing an appropriate amount in developing that new business line properly.

The entities we visited made clear that one of Jersey's strengths is our ability to handle complex client structures, with the technical skills of individuals here being a key determining factor. Jersey's general reputation is also a strong selling point.

Of course we also asked about challenges. On the client facing side, firms talked about the increased costs of reaching out to the wider world to gain business, and the way that second and third generations of families expect to be able to deal with them in very different ways technologically than the original, in most cases, *paterfamilias*.

In common with other intermediaries, trust businesses mentioned that some banking facilities are becoming more difficult to obtain, a point that hasn't gone un-noticed by regulators internationally. For example, only last week the FATF released a statement saying '…institutions should be aimed at managing (not avoiding) risks…. What is not in line with the FATF standards is the wholesale cutting loose of entire countries and classes of

customer, without taking into account, seriously and comprehensively, their level of money laundering and terrorist financing risk and applicable risk mitigation measures for those countries and for customers within a particular sector'.

These were free and frank discussions, so costs were also brought up in the context of regulation – and comments were made about the need for compliance staff to be able to take a risk-based approach, a point I will return to later.

Participants and the Commissioners agreed this dialogue was useful, so we may look to repeat the exercise; and in the meantime, we are thinking about what we can do as a Commission to deal with any barriers within our gift to address. Of course, we also welcome feedback from firms that weren't part of the visits.

The industry discussion I've just mentioned is one way that the Commission interacts with the regulated community. It's important to remember that the Commission is, and wants to be, an accountable organisation – formally to the States of Jersey, but also in some ways more widely to financial services businesses, their clients and the Island's wider population.

In terms of formal accountability we publish a Business Plan and Annual Report - both available on our website - and this year we held a meeting for States' members to present our Annual Report to them and answer any questions.

Without stealing my Chairman's thunder for a future event, I'd like to spend some time now looking at how we have fulfilled the tasks set out in our 2015 Business Plan. In reality, many of these are multi-year pieces of work, but I can give you an indication of where they currently stand.

Like most regulators, our objectives – referred to as 'guiding principles' - are set out in statute. These principles inform our four strategic priorities, which are:

- to develop strong supportive relationships with government, industry and consumers;
- to maintain and develop successful relationships with international regulatory bodies;
- to foster responsible behaviour and effective risk management within firms; and
- to become a more thoughtful, agile regulator

Our aim in doing so is to facilitate industry access to markets – crucial; to match international standards, and to meet other legal requirements placed on the Commission. And of course in looking at specific discrete projects, it's important not to forget what could be described as the 'ordinary' day job of supervision and authorisation of entities.

We highlighted ten projects for 2015. Some of these I'm going to group together and talk about later when I get on to the subject of change at the Commission. Thinking about the remainder, we can't start with anything other than MONEYVAL.

A group of assessors from MONEYVAL, or to give it its full title, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, visited the Island in January this year to assess the jurisdiction. They spent time with the

Commission, the police, the States and also individual firms asking a large number of searching questions about our laws, regulations and how things worked in practice. A few months ago we received a draft report, and some preliminary discussions were held in Strasbourg on its contents.

We have now had confirmation that the formal discussion on Jersey's assessment will be held on the 9th December at the MONEYVAL plenary, meaning we would expect to see publication of the final report sometime in the New Year. The Commission and other authorities invested a lot of effort in preparation for MONEYVAL – the Island will be rated on various criteria; in turn those ratings will be a key influence on others' views of the effectiveness of our AML/CFT regime – and the ratings we get now stay in place until the next assessment, which may not be until 2021.

Once our report is finalised, there will likely be some recommendations for change to be taken forward in 2016. We are cautiously optimistic about the outcome, but nothing is certain until after the plenary.

Our MONEYVAL visit was something of a hybrid between previous assessments – which have mainly been based on whether laws and regulations were in place – and what international bodies are increasingly moving towards – which is assessment of actually how effective those laws and regulations are in practice. This is a key shift in approach by the international regulatory community which has implications for both the Commission and regulated firms.

We have been working with industry and government on a review of our funds regime. The growth we have seen in the industry this year is impressive, but I think most people would accept that there could be some simplification, while still aiming to maintain the flexibility that currently exists. To date this year has seen a lot of the ground work done, paving the way for deliverables in 2016.

Alongside that, we should celebrate the big achievement for Jersey this year in being one of the first jurisdictions to gain a positive assessment from ESMA for our regime, relating to our ability to gain a '3rd country passport' for the purposes of the Alternative Investment Fund Managers Directive.

ESMA is the body which brings together all of the EU's securities regulators, and to gain an endorsement of this type is a genuine 'feather in the cap' for Jersey in terms of market access, particularly given that other jurisdictions weren't successful in the first wave. The path to the passport itself has more stages to go, but we couldn't be in a better position at the moment.

Civil financial penalties. The various legislative measures to enable the Commission to levy financial penalties on wrong-doers, in certain circumstances, came into force earlier this year. I would point out that – contrary to some views expressed at the time – we haven't seen our Director of Enforcement Barry Faudemer skipping down the street throwing out fine notices like confetti.

The Commission recognises the controversial nature of this subject. However I would like to make three points in support of the power. First, in terms of acting proportionately, surely it

is sensible for the Commission to have a variety of regulatory options when wrong-doing occurs between 'do nothing' or the rather 'nuclear' option of 'shut down the firm'.

Second, and I would have thought importantly to you, civil penalties will to some extent mean 'the polluter pays'. At the moment the costs of Enforcement action are borne by all firms. Although a penalty would not be calibrated on the costs of action, and the Commission may have a general preference for money to be used to provide restitution to clients where that is appropriate, the fact is that penalties received by the Commission are credited against industry's future years' fees and not – another rumour – spent on providing Commission staff with lavish bonuses or a slap-up Christmas party.

Finally, but not least, to put it bluntly, in my view no regulator without this power will be taken seriously in international assessments that are key for market access. In the series of reforms of financial services law undertaken by the European Commission in the light of the financial crisis, the sanctioning powers available to regulators were a key focus, and I have no doubt this will be the case when Jersey is being evaluated, be that for the AIFMD or any other purposes.

Basel III implementation. If possible, I'd prefer no questions on this! Those affected will have seen our consultation paper on capital adequacy and leverage, which closed a couple of weeks ago. There is clearly further work and industry dialogue on this topic needed as we work towards the 2019 implementation date, and we expect to hold some workshops with firms next year.

In 2016, the Commission expects to be brought within the remit of the Freedom of Information Law. This is another accountability mechanism and we have been reviewing our information management protocols to create a process so that we can deal with requests accordingly.

While a somewhat dry phrase, information management – how we gather, analyse and use data, is increasingly one of the key factors in how effective and efficient we can be. I'm sure the same is true of your firms as well in terms of client information. Freedom of Information is not about us releasing confidential details we hold about regulated entities; based on my experience with the FSA in the UK, I would expect many of the questions to be around 'value for money' issues on the Commission's budget.

The Commission continues to work with Government to develop and host a number of different registers and in some cases to also run them. Work has been carried out by the Commission in the areas of aircraft, trademarks and the securities interest register for tangible assets. In 2016 we will move, where appropriate, into a building and testing phase, including for the enhanced Registry platform.

Finally, MiFID 2. MiFID is the EU financial services legislation that covers investment business and exchanges. As an Island we need to decide our response, given that a material amount of investment business that our firms do is with clients in the EU. This is another key example of the role of the Commission in ensuring market access for Jersey firms.

Our positively received work on the AIFMD perhaps provides a way to approach MiFID, and we are in a similar position as we were on the AIFMD of not yet having final requirements or knowing how the UK (one of the main client centres for our firms) is going to implement some key parts of the legislation.

It is possible that, unlike the AIFMD however, we will not be able to have a bifurcated regime – that is, MiFID requirements would need to apply to all investment business conducted in the Island. As you might expect, MiFID's requirements are more detailed than our current Investment Business Codes of Practice. However we still need to get clarity on the possibilities.

During 2015 we have undertaken a lot of research with firms to understand their business needs, and this process will continue next year.

At this point I'd also like to mention the Financial Ombudsman, who will start work very soon. While not applicable to the majority of trust business, the creation of an Ombudsman is a key development in the regulatory framework of the Island, affecting in particular investment businesses and banks, as well as the Commission.

My last topic today is change at the Commission, and how it will affect the regulated community. The Commission is currently going through a programme of change, with the aim of becoming a more effective and easier-to-deal-with regulator.

Why are we doing this? Like many regulators, during the financial crisis we had to apply all hands to dealing with the day-to-day unfolding issues and how they affected Jersey. There was little time to deal with wider issues, or invest in improving our systems or processes. To take a very small but quite visible example, one thing that surprised me when I joined the Commission was being regularly asked to sign paper authorisation certificates. Why is this necessary, when we have a perfectly good register of entities on our website?

As well as becoming more efficient, we have an ongoing desire to become more *effective* as a regulator. Effectiveness can be considered in a number of ways, but to mention two drivers: first, we carried out a detailed review of some of the most serious cases we have dealt with, with the aim of drawing out lessons for us where doing things differently may have mitigated some of the outcomes; and secondly, as I mentioned previously, being able to prove our effectiveness to others – rather than that we just have the appropriate legal framework in place – is of increasing importance for the Commission and the Island. More is expected of regulators than ever before.

Just as an aside, we recognise there is something of a tension here. How do you demonstrate the direct link between an action taken by the Commission now, and the prevention of something 'bad' happening in a later period? While logically it must be the case that the most effective regulator is one that stops bad things happening very early on, the most visible regulator would be one handing out the fines like confetti once the harm had occurred. We don't want to take that route; we want to 'pick important problems and fix them'[1].

[1] Malcolm K. Sparrow, 'The Regulatory Craft'.

Finally, and not least, we need to change because our staff deserve it. We need to be able to offer interesting and rewarding careers that encourage talented, thoughtful, people to come to work at the Commission.

So what does this mean in tangible terms?

First, we are investing in overhauling our key IT infrastructure. We will be doing this in an iterative way, so that we can test and prove changes to ensure they deliver defined improvements internally and externally. The benefits for you? An easier to deal with Commission, where your firm has an electronic gateway to do business with us. Less paper, electronic payment options, quicker processing times as less need to re-key information. Enabling us to move to a 'tell us once' culture with regard to information, and to be more efficient at accessing the information we hold. We aim on this front to reduce your indirect costs of dealing with the Commission.

Second, we will be changing the way that we supervise. On an organisational front, we will be moving from supervising firms on a 'per licence' to a 'per entity' basis. Where your firm currently holds multiple registrations – for trust company business and fund services business for example – this will affect you.

Supervising on a 'per licence' basis allowed areas of specialism to develop within supervision; but it also meant that your firm was potentially subject to multiple examination visits which overlapped in some cases, and multiple points of contact at the Commission. Ironically, it also meant on occasion that issues fell between the cracks of separate supervisory teams or there were unclear areas of responsibility. Supervision at an entity level will avoid these problems; and we intend to maintain specialists within the separate entity teams, who will co-operate across the Commission to ensure knowledge is shared and maintained.

The teams themselves will be based on what we see as the predominant business models on the Island:

- banking firms;
- combined fund and trust company businesses;
- standalone trust company businesses and designated non-financial businesses and professions; and
- standalone fund managers/advisers and investment businesses (as well as our relatively small insurance population).

The other supervision development is that we will be creating a small but focussed risk team, who will have a remit to consider issues on a 'macro' as well as an individual firm basis. This will work as a feedback loop: the team will be able to consider whether an issue found in an individual firm is indicative of a broader sector-wide risk that needs investigation. It will also be able to provide aggregated risk data which will help answer the type of question such as 'What is the level of risk of terrorist financing in Jersey?'

Increasingly, these sorts of questions are the starting point for the international assessments to which we are subject, and the inability to easily present a convincing answer will put a

jurisdiction on the back foot. Of course the answers to these sorts of questions are also of importance to all the stakeholders to whom we are accountable.

Apart from structural improvements, we want to alter the nature of some of the conversations we have with firms. Over my career I've seen changes in the way that regulation 'operates' – rules-based, principles-based, governance-focused, outcomes-focused, culture-focused – but what we are trying to understand are the key risks in a business, and whether they are recognised, understood and mitigated. How a firm makes its money is often a good question to start with in this regard.

Policies and procedures have their place, but a little like assessments of the regulatory framework, it's what actually happens in practice that is important. We hope that our developing approach will have a positive secondary effect in reinforcing compliance officers' comfort in taking a sensible and robust, but risk-based approach, to business.

So we will also be looking to re-develop the risk model that we use to assess firms. Parts of the current version date back to the late 1990s and the model isn't sufficiently responsive to new risks or appropriate for the kind of learning organisation that we want to be. As part of this, we need to review the data we currently ask you for. We will robustly assess both our existing data requests and any proposed new items to see whether they will genuinely assist in risk identification or mitigation. We have no interest in collecting data just for the sake of it.

So - better systems giving you an easier-to-deal-with Commission. Better conversations with you about your business and a better targeting of regulatory resource to areas where risks aren't adequately mitigated, helping to protect your firm from the reputational risk to Jersey as a whole that arises from wrong-doing. These things in themselves mean working at the Commission will be more interesting, but over and above that, investment in our systems needs to be matched by investment in our people, whether that be training – technical or soft skills – or wider use of flexible working, the removal of 'boring' bureaucratic tasks or the myriad of other aspects those joining a modern organisation now expect as routine.

To continue on an HR theme for a moment, recently the Commission has experienced a material level of turnover in its supervisory divisions. Our staff are in demand, in particular for compliance and risk roles. Occasionally the comment is made that the movement of regulatory staff to the industry should be viewed as flattering by the regulator, and will help the spread of good compliance practice within the industry; potentially all true, but I hope you agree that everything I've said up to now indicates the need for the Commission to have a base of skilled staff to operate effectively.

Now, to be clear, what this doesn't mean. The regulator will not match industry salary levels, nor should it. But it can't afford to fall so far behind, and particularly in some sectors the differences have become material. Neither are our proposed changes about increasing headcount: we plan to achieve our supervisory reform with the same number of people as the Commission has had to date. The investment in upskilling those people is necessary for the change to succeed. I also need to point out that all this change will not happen overnight! You should expect to see incremental improvements, and we are committed to industry outreach as we go through these developments.

I've started to talk about costs, and the eagle-eyed amongst you may well have already looked at the Commission's recent consultation about how we raise our fees. Rather than being about the amount of fees *per* se, that document is more about creating a more rational and efficient framework of how we go about collecting them. But I would ask you to reflect on these three points:

- between 2010 and 2014, the Commission's fee income rose 9%; in the same period the UK regulators' fees rose by more than 40%;

- if you think that a direct comparison between the UK and Jersey is probably not the most instructive, in 2014, Guernsey's regulator charged its regulated community in excess of £2m more than the Commission; and

- the Commission's 2014 fee income was actually lower than in 2013.

I'm not going to labour this point further today, because I think I can just detect the sound of the world's smallest violin playing somewhere in the background. But there is a serious point here about the need for the regulator to be adequately resourced, given its key role in ensuring market access for the industry, and this will be a developing subject next year.

To conclude, I just want to reflect on the very human element to all our work. I mentioned whistleblowers earlier, and I've described the Commission's change programme. I'm sure that many of you have worked in organisations undergoing change or restructuring, and know the importance of people in making that change happen successfully.

Equally, when talking about supervision findings, we are wont to refer to 'firms' or 'entities' having done things. But what sometimes gets forgotten is that every supervisory issue we have to deal with results from action or inaction – choices and decisions – by individuals. It is the individuals that make up the firm that cause the action or inaction to happen.

STEP describes its vision to be the pre-eminent worldwide professional association for those advising families across generations. One of the main ways it does this is by supporting you – the individual members – with professional and ethical development and training. Your individual decisions have a key effect on the outcomes for clients and the regulatory health of the industry. We gain confidence from the fact you have chosen to develop with STEP.

Thank you