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KPMG's Regulatory Update

An overview of the latest in Bermuda's financial services legislative and regulatory news

November 2018

The Bermuda Monetary Authority (BMA) continues to strengthen the regulatory landscape of Bermuda. From cyber currency to cybercrime, the use of technology is ever changing and the role of the regulator is to strike the balance between financial stability and economic growth. A clear message coming from the BMA 2018 business plan is that innovation is at the forefront of regulatory developments and this is going to continue into the future.

Highlights

1. Insurance and Reinsurance Sector Regulatory Update – innovating supervision, BSCR updates, Insurance Manager, Brokers and Agent updates
2. Banking and Asset Management Sector Regulatory Update – proposed regulation of financial holding companies, EU Economic Substance Requirements
3. Fintech Regulatory Sector Update – Initial Coin Offering, Digital Asset Business Act
4. AML/ATF Sector Regulatory Update – general updates

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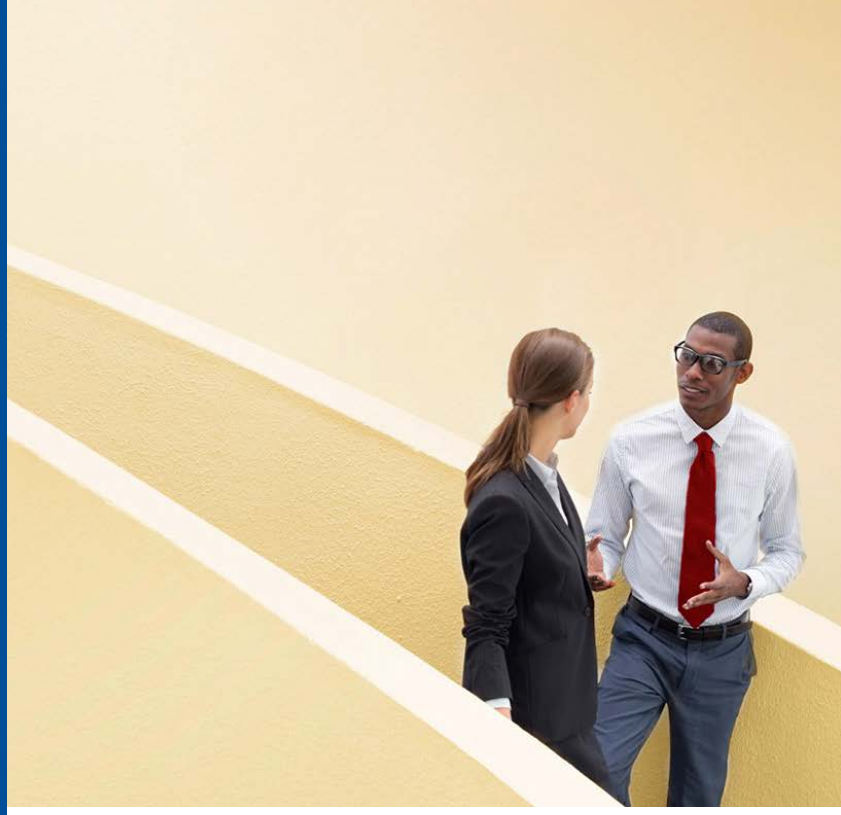

1. Insurance and Reinsurance Sector Regulatory Update

Innovating Supervision

The Insurance Innovation Committee ('Committee") was created in 2017 and has developed a cyber supervision regime, including enhancements to the Capital and Solvency Return for disclosures about cyber-related data for commercial insurers and reinsurers. The Committee has also worked with financial technology experts from industry to identify components of a sound regulatory regime for fintech. The Committee is now focused on the regulatory sandbox and innovation hub for insurtech, recognizing the growing importance of disruptive technological innovation in financial services and the critical role that innovation plays in promoting efficiency and enhancing competitiveness in the market.

The sandbox will enable firms to test new technologies and offer innovative products and services to a restricted number of customers in a controlled environment for a limited time. The sandbox environment, with appropriate safe guards for customers, will be covered by a special license for its business model. Following the testing period, the firm will leave the sandbox and obtain to a license under an existing entity class becoming fully subject to the relevant legal and regulatory requirements by the BMA. The aim of the sandbox is to create a "safe space" for innovation within the industry. The innovation hub will provide a forum for insurtech service providers to exchange ideas with the BMA and also to promote closer dialogue for the insurtech industry allowing them to obtain guidance and clarification with respect to regulations. It can also be used by companies that will eventually apply for entry into the sandbox.

The eligibility criteria includes the following:	The application and approval process includes the following:
The proposed business model must be new technology or it should be using an existing technology in a different way.	**Application:** An organisation applying to use the sandbox will verify that it satisfies the eligibility criteria and then submit an application to the Authority, together with the requisite fee.
Research and due diligence on the proposed product or service must have been conducted by the organization in advance.	**Review:** Applications will be reviewed by the Assessment and Licensing Committee for sandbox which is composed of senior management from the Licensing & Authorisations, Fintech, Insurance Supervision, Actuarial and Anti-Money Laundering Departments within the Authority.
There should be clearly defined objectives for testing and the expected outcomes of the sandbox proof-of-concept stage.	**Proof-of-Concept:** After approval of the application, the organisation will commence the proof-of-concept phase which will typically last between six and 12 months
The organization must be able to demonstrate their understanding and assessment of associated risks of the proposed business model and have the ability to deploy the proposed product or service after successful testing and exit from the sandbox.	**Deployment:** After completion of the proof-of-concept phase, the organisation must submit a final report to the BMA on the outcomes of the testing phase, including client feedback on its products, services and delivery mechanisms. The BMA will then decide whether the organisation can offer the proposed solution outside of the sandbox. The organisation will then be required to complete a "change of class" application and if approved by the Authority, the company will be issued a license to operate outside of the sandbox in accordance with the company's business model and existing insurance licenses.

Guidance notes were released in September along with an application form checklist outlining the eligibility criteria and the application and approval process for insurtech companies to enter the sandbox. The below provides an overview:

Bermuda Solvency and Capital Requirement (BSCR) updates

Following a period of consultation, the BMA announced in July, 2018 a series of changes which will come into force from January, 2019:

- The current duration based approach for interest rate and liquidity risk will remain unchanged. It is a simple approach with well-known advantages and limitations. Insurers will now have the option of continuing with the duration-based BSCR method or moving to the proposed shock-based method. However, once using proposed shock-based method insurers will not be able to revert back to the duration based method without prior supervisory approval. The BMA will further consider the process and frequency of updating the interest rate shocks.
- There have been minor changes to the definition of strategic holdings for the purposes of calculating the equity risk charge to make it more in line with international accounting standards.
- There has been an extension granted to the grandfathering of equity charges to the concentration risk calculation.
- There have been clarifications to the calculation of the operational risk charge, namely that it should be applied after consideration of the risk mitigation effect of management actions (by reducing liabilities for future bonuses or other discretionary benefits).

The final version of the new rules was published in July 2018. Not all provisions presented on the BSCR Update Proposal March 2018 were transposed in the form of rules; some will be transposed in the form of instructions and guidance to be included in the respective upcoming BSCR handbooks to be released in the fourth quarter. The 2018 year end BSCR models will contain the trial-run schedules but these will be for information purposes only as filing is voluntary at this point. Does this mean that the filing will be compulsory from next year?

Insurance Manager, Brokers and Agent Updates

In August, the BMA issued a new annual return template and new supplementary rules for Insurance Managers, Brokers and Agents. The first filing of the revised template is due on or

before June 30, 2019. Brokers and Agents will be brought into scope as a result of the release of a BMA consultation paper on the Insurance Brokers and Insurance Agents Code of Conduct, including amendments to the Insurance Act which was issued for consultation in the summer. Comments on the consultation paper were due by September 7 and we expect it to be finalized over the fourth quarter. Insurance Managers, Brokers and Agents will now be required to complete a comprehensive annual return filing including additional schedules to what was required previously. The new schedules include completion of questionnaires on the Company's Cyber Risk Management Framework, Anti-Money Laundering (AML) and Anti-Terrorist Financing (ATF) Risks and Control Framework, and Corporate Governance and Sanctions and Screening policy.

What does this mean for you? If you are an insurance manager, broker or agent, you should be taking steps now to ensure you are able to readily access the required information. The annual return requires a copy of your AML/ATF annual audit to be submitted along additional information to be submitted to the BMA.

BMA Insurance Digest

The BMA also issued its first Insurance Digest in June 2018. The publication provides an overview of the Bermuda insurance group supervision regime and how it has evolved over the past six years and what the future of Bermuda group supervision holds. The key areas of focus within the group supervision framework as we move forward are:

- Ensuring solvency at group level
- Monitoring intra-group transactions, including unregulated entities in the group that could compromise the solvency of the group; and
- Assessing key control functions such as corporate governance, risk management, actuarial and internal control processes of insurance groups.

2. Banking and Asset Management Sector Regulatory Update

Enhancing the Investment Business Regime

The BMA aim to introduce enhanced legislation for fund administrators and develop legislative proposals for investment businesses to bring Bermuda's regimes in line with international best practice including compliance with the European Union and International Organisation of Securities Commissions (IOSCO) standards. In March 2018, the BMA issued the Discussion Paper, which proposed a series of potential enhancements to the Investment Business, Investment Funds and Fund Administration regimes (the Investment Regimes) in relation to strengthening supervisory requirements. The intent of the paper was to seek feedback from stakeholders within the financial services sector on proposals related to the respective frameworks.

The overall feedback on the Discussion Paper was favourable, with respondents generally supportive of the rationale for, and merits of, the proposed enhancements to the Investment Regimes. Stakeholders clearly expressed their wishes to be consulted with by the BMA as it seeks to advance more definitive proposals. In addition, stakeholders requested that the competitiveness of Bermuda as a jurisdiction within the global industry be considered throughout the deliberation process, and that amendments to the Investment Regimes be of a reasonable and proportionate nature. The BMA has communicated that it will, in the first instance, be moving forward with proposals related to fund administration via the development of a standalone legislative framework for fund administrators by year-end 2018.

Proposed Regulation of Financial Holding Companies

The BMA released a discussion paper in May this year in order to prompt discussion and receive feedback from the industry on a proposed structure of regulation of Financial Holding Companies (FHCs) in Bermuda. Comments on the discussion paper were due by July 31st. The discussion paper outlined a list of proposals for the proposed Act which was not intended to be an exhaustive listing but rather a sample of the issues that must be considered. A summary of the proposals is outlined below:

1. Only FHCs designated by the BMA would be subject to the proposed FHC regulatory framework.
2. In determining whether to designate a Bermuda-incorporated FHC for regulation, the BMA would consider the following conditions:

    (a) Whether the FHC is the parent of a financial group, that has a bank or insurance or other regulated financial subsidiary in Bermuda

    (b) Whether the FHC is an intermediate FHC under a parent FHC or regulated financial institution in Bermuda and whose subsidiaries in Bermuda are significant to the jurisdictions financial system

    (c) In the case where there is no holding company in Bermuda; and

        (i) The parent group of which the intermediate FHC is a member is not subject to group-wide supervision by its home supervisor

        (ii) The FHC's subsidiaries in Bermuda are significant to the local financial system, or to the intermediate FHC group.
3. Non-designated FHCs incorporated in Bermuda with at least one regulated financial subsidiary in Bermuda may be required to submit information on the financial group to the Authority.
4. The scope of the group for a designated FHC would include, at a minimum:

    (a) In the case of a Bermuda parent FHC, the parent FHC and all Bermuda regulated subsidiaries;

    (b) In the case of an intermediate FHC in Bermuda that is part of a larger Bermuda based financial group, the intermediate FHC and all subsidiaries both local and overseas;

(c) In the case of a foreign-owned intermediate or ultimate FHC, the controlling intermediate FHC in Bermuda and all subsidiaries both local and overseas

5. The shareholding and control thresholds would be consistent with the requirements stipulated in the Business Act (BA) or Insurance Act (IA).
6. The FHC Act would provide for corporate governance regulations on the roles and responsibilities of directors, and the appointment of key persons such as the board/board chair of the FHC.
7. All FHC groups would be required to develop and maintain appropriate capital management policies, and capital planning processes that consider risk assessment on a group-wide basis. The FHC's board of directors would be responsible for approving and reviewing the capital management policies, and capital planning processes, as well as the capital plans and group-wide risk assessment.

This discussion paper came as no surprise as the BMA continue to remain in line with international regulatory standards. The US, Australia and Canada have established a legal framework for the regulation of FHC and it is against this backdrop that they decided to explore the approach of direct regulation of the parent financial holding company. The BMA is aware that the issue of the regulation of FHC is a complex one and after critical analysis of the feedback from industry stakeholders is completed it is their intention to follow up with a Consultation Paper and draft legislation; watch this space.

EU Economic Substance Requirements

The Council of the European Union released "commitment letters" over the summer regarding a number of jurisdictions, including Bermuda. Although noting Bermuda's "long standing and constructive relationship with the EU," and committedto address the concerns about "defacto lack of substance for entities doing business in or through Bermuda." Bermuda, while not listed as a "non-cooperative jurisdiction," was placed on a secondary list along with over 60 other nations and territories and has committed to addressing concerns relating to economic substance and pass legislation to implement appropriate changes by the end of the year. The EU's intention is to clamp down on international companies that reduce their tax bills in Europe through the use of legal, multinational corporate structures, utilizing low-tax domiciles. It seems likely that those companies who employ no one, whose physical presence is limited to a drawer in a law firm's filing cabinet and which nevertheless book large amounts of profit will be the major targets.

Highlights from the proposed Economic Substance policy

- It is anticipated that some entities will be deemed to comply with Economic Substance Requirement (ERS) due to other regulatory frameworks which are already positioned to alleviate the overall concerns underpinning ERS such as:
  - Insurance Act 1978,
  - Investment Business Act 2003: and
  - Digital Asset Business Act 2018.
- Consideration is being given to taking into account the number of Board meetings at which two (2) or more Board members are physically present in Bermuda.
- Annual Economic Substance Requirement filing to be submitted.
- Consideration is being given to requiring that entities subject to ESR provide copies of financial statements for the reporting period.
- Substantive requirements will apply to exempted entities that are not tax-resident in the EU.
- Failure to comply with ESR will result in fines, to be increased in amount for non-compliance in consecutive years. In the event of 3 consecutive years of non-compliance, it is proposed that the Registrar of Companies be authorized to strike the company off the register.

3. Fintech Regulatory Sector update

Initial Coin Offering

The Companies and Limited Liability Company (Initial Coin Offering) Amendment Act, 2018 (the "ICO Act"), which amends both the Bermuda companies and limited liability company legislation, came into force on 9 July 2018, providing a framework for the regulation of initial coin offerings in Bermuda. The Companies (Initial Coin Offering) Regulations 2018 which came into effect on 10 July, 2018 further expanded on certain requirements under the ICO Act.

Initial Coin Offerings, or ICOs, are fundraising mechanisms similar to Initial Public Offerings, or IPOs, except that tokens, rather than shares, are issued. The ICO Act regulates offerings of 'digital assets', a term that applies to all categories of digital assets being issued as ICOs. The purpose of the ICO Act is to regulate those ICOs which are public crowdfunding or similar type projects. The ICO regulations set out the minimum required information for ICOs and outlines the compliance measures that a company or limited liability company must adopt when conducting an ICO. For more information on the ICO application process please refer here.

The legal framework only applies to public offers. ICOs carried out through totally private sales or ICOs sold to persons whose ordinary business involves the acquisition, disposal or possession of digital assets are not covered in the new legislation. Such businesses, as well as those operating digital asset exchanges, e-wallets and similar structures, will be regulated by the Digital Asset Business Act, which is outlined below.

Digital Asset Business Act

The Digital Asset Business Act (DABA) was passed in May this year clearly demonstrating how Bermuda continues to become a world leader in the Fintech regulatory environment. The island has embraced new technologies and we have become accustomed to

terms like "ICOs", "block chain", "digital assets", "fintech", "crypto", "insurtech" and many others as the Government and the BMA have developed a legislative and regulatory landscape to minimize risks surrounding this technology.

DABA will regulate digital-asset business (unless otherwise exempt) carried on in or from within Bermuda, including payment service providers, electronic exchanges, custodial wallet services and market makers or traders of digital assets.

What is a digital asset?

A "digital asset" means anything that exists in binary format and comes with the right to use it and includes a digital representation of value that:

- is used as a medium of exchange, unit of account, or store of value and is not legal tender, whether or not denominated in legal tender.
- is intended to represent assets such as debt or equity in the promoter.
- is otherwise intended to represent any assets or rights associated with such assets.

A digital asset does not include a transaction in which a person grants value as part of an affinity or rewards programme, which value cannot be taken from or exchanged with the person for legal tender, bank credit or any digital asset or a digital representation of value issued by or on behalf of the publisher and used within an online game, game platform, or family of games sold by the same publisher or offered on the same game platform.

Applications for a digital business asset license are submitted to the BMA's Assessment and Licensing Committee as outlined in the recent information bulletin issued in September. There are two classes of DAB license available; Class F which is a full license and Class M which is a modified license.

The BMA will approve a license for digital assert business subject to the minimum criteria set out in Schedule 1 of DABA. This includes:

- Having controllers and officers who are fit and proper persons;
- Having policies and procedures in place relating to AML/ATF, sanctions and the codes of practice under DABA;
- Maintaining minimum net assets of $100,000 or such amounts as the BMA may determine taking into consideration the nature, size and complexity of the licensed undertaking;
- Maintaining adequate accounting or other records and adequate systems of control of its business and records;
- Having insurance to cover the risks inherent in the operation of its business of an amount commensurate with the nature and scale of its digital-asset business or has implemented such other risk mitigation measures as the BMA may agree; and
- Being effectively directed by at least two persons and under the oversight of the board with such number of non-executive directors as the BMA considers appropriate given the nature, size, complexity and risk profile of the licensed company.

Code of Practice for Digital Asset Business

In September, the BMA issued the Code of Practice for Digital Asset Business.

- The Code of Practice was released pursuant to section 6 of the Digital Business Act 2018 which requires the BMA to publish a Code that provides guidance on the duties, requirements, procedures, standards and sound principles to be observed by persons carrying out Digital Asset Business.
- The DAB must establish and maintain a sound corporate governance and risk management framework along with implementing client due diligence and monitoring procedures, internal management controls and also a requirement for an internal audit to be undertaken. The BMA recognizes that DABs have varying risk profiles arising from the nature,
- Scale and complexity of the business and therefore compliance will be assessed in a proportionate manner.
- The Code should be read in conjunction with the DAB Statement of Principles issued under section 5 of the Act.
- Copies of the Statement of Principles and Code of Practice, as well as additional forms relating to the Digital Asset Business can be found in the Document Centre under Policy & Guidance/DAB.

The BMA issued Sector-Specific Guidance Notes for Digital Assets Business which outlines the AML/ATF obligations under the Act and Regulations that are specific to digital asset business. Guidance issued should also be supplemented with the 2016 Guidance Notes for AML/ATF Regulated Financial institutions (RFI) on AML/ATF. All RFIs providing DAB services need to comply with the main AML/ATF guidance notes issued by the Authority. The BMA will take into account any failure to comply, among other things, with:

- DABA;
- The Proceeds of Crime Act 1997;
- The Anti-Terrorism (Financial and Other Measures) Act 2004;
- The Proceeds of Crime (Anti-Money Laundering and Anti-Terrorist Financing) Regulations 2008 (Regulations);
- International sanctions in effect in Bermuda.

The guidance covers numerous areas aligned with already established RFI guidance including but not limited to:

- Senior management responsibilities and internal controls including fines and penalties ranging between $50,000 - $10,000,000 for individuals/entities;
- Ownership, management, employee and agent checks;
- Cyber Security;
- Business Risk Assessment (BRA);
- Customer Due Diligence (CDD) and Enhanced Due Diligence, Customer Transaction/business relationship with RFIs;
- One-off transactions, occasional transactions, and business relationships.

- Transaction Monitoring Tool/Reporting;
- Source of wealth and Source of funds; and Risk factors (for digital asset business).

"We are also introducing exciting approaches with respect to supervisory technology (SupTech), working with respected technology firms, such as CipherTrace, to implement blockchain analysis (i.e., tracking transactions across the blockchain), and separately testing the implementation of artificial intelligence and machine learning across our financial sectors to enhance our AML/ATF and prudential analytics. While these efforts are internal, the Information Bulletin and aforementioned legislation provide both certainty and an external indication of both the practical and robust nature of our digital asset business regulatory approach."

From a recent press release from:

Craig Swan,
Managing Director, Supervision,
Bermuda Monetary Authority

4. General AML/ATF Update

The Caribbean Financial Action Task Force (CFATF) mutual evaluation review of Bermuda's AML/ATF framework took place in September and October 2018. Since 2014 more than 50 jurisdictions have been evaluated under 2012 Financial Action Task Force Standards. Ahead of this, a number of changes to existing regulation and legislation has been announced.

Notice to Regulated Entities on Delegation of Governor's Functions for Sanctions

The new Financial Sanctions Implementation Unit ("FSIU"), within the Ministry of Legal Affairs, is now the administrative touch point for matters relating to Targeted Financial Sanctions in Bermuda. Sanctions breaches should now be reported to the FSIU rather than the Governor.

What does this mean for you? All organizations should update their sanctions policies and procedures to reflect this change in reporting.

Enforcement Guide: Statement of Principles and Guidance on the Exercise of Enforcement Powers

The BMA have issued this guide which outlines the circumstances in which an RFI may be referred from supervision to enforcement and how the enforcement process proceeds thereafter. This explains that a breach of AML/ATF requirements will always be considered potentially serious and therefore will be referred to enforcement. These may also be considered a prudential breach or a breach of the minimum criteria for licensing. Notably, the document explains that this may give rise to concerns about the fitness of individuals within the organization or to wider corporate governance concerns. Likewise, a breach of sanctions requirements identified during an onsite would be viewed as serious and almost certainly referred to enforcement and possibly to the Bermuda Police Service.

Once a matter is referred to enforcement, the Chief Enforcement Officer will consider what action to take, if any, bearing in mind 1) whether there is a failure to comply 2) the gravity of the breach and 3) whether the matter fits within the enforcement and strategic priorities of the BMA. The BMA will communicate the referral to the RFI and there should be continuous collaboration. The statement includes details of factors which would be taken into account in establishing the extent of enforcement action and the powers the BMA has to enter premises and require documentation from third parties if they believe an RFI is providing misleading information.

The ultimate decision regarding enforcement is taken by the CEO of the BMA, issuing first a Warning Notice to the RFI (which can be challenged by the RFI) and then a Decision Notice to the RFI, explaining what action is being taken.

Finally, the statement includes information about what is done with the revenue generated from fines. Along with licensing fees, these go towards funding the operations of the BMA, including the cost of enforcement. Revenue from penalties must be used for funding AML/ATF supervision of the Authority.

So what has changed here? The main purposes of this is to provide further transparency around the supervision and enforcement process.

Updates to the Proceeds of Crime (Anti-Money Laundering and Anti-Terrorist Financing and Supervision and Enforcement) Act 2008 ("the SEA"), Section 9

The SEA was updated in August to criminalize the conducting of business without registering with the relevant supervisory BMA as a non-licensed person ("NLP"). Guidance was subsequently issued by the BMA in relation to scope of registration under Section 9 of the SEA. The obligation applies only to institutions that are not licensed, registered or authorized under any of the regulatory acts (i.e. licensed under the Investment Business Act, the Investment Funds Act, etc.).

Additionally, NLP registration has now been extended from asset management sector to businesses which provide lending, leasing and financial guarantee services. Any such businesses are required to register prior to December 7, 2018.

We welcome the opportunity to discuss with you how these updates may impact your business. Please reach out to me or your KPMG contact.

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