

Your World First



Developments on Brexit and update on FCA/PRA regulation

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Looking at ...

Compliance culture & incentivisation

Price regulation

Product governance

The targets for the SMR regime

Brexit

- Why is financial services important to the UK?
- What does Brexit mean?
- What is the model?
- What are the options?
 - At national level – passporting & equivalence
 - “Build your own Brexit”

Establishing & incentivising compliance culture

Changing compliance choice architecture

FCA: Occasional Paper 24 2016: Behaviour and compliance in organisations (December 2016)

Changes to choice architecture	Actions for firms	Actions for regulators	Drivers of poor behaviour this addresses
Changing perceptions of detection and punishment		Making punishments and detections salient and vivid; making regulatory communications of detections and punishments salient and vivid.	Salience and vividness bias; overconfidence.
De-biasing firms' decision making	Use of internal scrutiny and decision tools to minimise the impact of behavioural biases on their decision making.		Endowment effects, loss aversion, confirmation bias.
Enhancing the role of morality	Use reminders and moral codes to engage moral reasoning; increase the salience of the consequences of non-compliance	Identify cases when the role of morality is reduced; improve regulation	Low salience of morals and distance from rule breaking.

How does HMRC incentivise compliance?

HMRC has developed policies and interventions **targeted at incentivising increased compliance** ...

- Ensuring that the **penalty for non-compliance is large enough** to provide a real incentive to comply, and recommending that at least some of the penalty should be borne by a senior executive of the firm ...
- Methods for **identifying non-compliance** among the whole population of financial institutions, such as an auditing strategy and third-party reporting. HMRC have moved to real-time monitoring of large businesses' tax compliance. The FCA has the data necessary to undertake real-time monitoring but the complexity of the task creates a technological challenge ... Real-time monitoring would be particularly beneficial for the early identification of mis-selling. The application of “big data” analytics should be a priority area for development at the FCA.
- Methods for **focusing on large or particularly important** financial institutions through closer engagement ...
- Methods for dealing with **financial institutions at high risk** of regulatory non-compliance, by high-level engagement and the mandatory disclosure of regulatory avoidance schemes, including, for example, products designed to avoid their natural and appropriate regulatory treatment ...

FCA Occasional Paper 25/16 Incentivising compliance with financial regulation (Dec 2016)

FCA as a price regulator?

Financial service markets can ... cause consumers to **pay different prices for equivalent products or services**, or pay the same price even though the cost to the firm of supplying them differs.

... increasingly, firms have the **data to model which groups of consumers, or which individual consumers, will be more price-sensitive** ...

Once **cross-subsidies become central** to how a market works, firms can become **highly focused on ways of extracting more and more profit** from trapped or otherwise price-insensitive consumers. Some level of cross-subsidy is inevitable, but beyond a certain point it can have harmful effects that threaten our objectives ... In future we will seek to be more transparent when we make judgements of this sort.

FCA: Our Future Mission (October 2016)

Price discrimination and cross-subsidy

... **Price discrimination** occurs where firms charge prices to different consumer groups, with different mark-ups on the costs of supplying the product to these groups ...

Cross-subsidy is commonly used to refer to the distributional consequences of price discrimination. Consumers who are charged high mark-ups may be considered to 'subsidise' those who are paying lower mark-ups

When we identify areas where either type of pricing is a concern, the **most appropriate intervention may be to address the market characteristic or consumer behaviour** that leads to such pricing, rather than to directly unravel the cross-subsidy by mandating cost-reflective pricing.

Direct regulation of prices in response to concerns raised by price discrimination raises considerable risks of stifling competition and unintended consequences; as such, it is **only likely to be appropriate in rare circumstances**.

**FCA: OP22: Price discrimination and cross-subsidy in financial services
(September 2016)**

Product governance

The MiFID II guidelines

Manufacturer

- a) Identify to differentiate ...
 - Who are you targeting?
 - Knowledge & experience
 - Loss absorbance & risk tolerance
 - Needs & objectives
- b) Articulate strategy
- c) Select distributors
- d) Define client information needs
- e) Regular review & dialogue
- f) Identify grey/black markets

Distributor

- a) Identify market
- b) Differentiate based on product & delivery method
- c) Define distribution strategy
- d) Regular review & dialogue

ESMA: Draft guidelines on MiFID II product governance requirements (October 2016)

What the SMR is seeking to achieve

1. CEO engagement

The business model that Mr Palmer developed and maintained ... allowed [agents] to be **afforded a high level of flexibility and freedom** as to how they could operate ...

Mr Palmer must have been aware that the Firms' business model **gave rise to material risks to underlying customers**, and of the need for appropriate controls and mitigating measures to be in place in relation to these risks ...

Although Mr Palmer **was not responsible** for the detailed risk management framework and compliance controls, **his role as the CEO** ... and his awareness that the business model gave rise to material risks to underlying customers, meant that he **could not simply rely on the Firm's directors** responsible for risk management and compliance to ensure that these risks were being identified and effectively managed

FCA Decision Notice: Charles Palmer (25 Sept 2015)

... It was incumbent upon Mr Joint [Director] to **inform himself as to the essential elements** of the client money rules...

The **delegation of authority** for the running of JASL's day-to-day business that Mr Joint gave to Mrs O'Brien **did not absolve him from responsibility** for taking adequate steps to inform himself regularly about the business and financial affairs of JASL and to monitor Mrs O'Brien's activities.

Mr Joint's practice of **never asking for any financial information** or **taking any interest** ... was unacceptable ... he had an **ongoing responsibility to monitor how Mrs O'Brien was performing** and to **identify any issues which required attention himself rather than leaving it to Mrs O'Brien to raise any issues with him**

Upper Tribunal: Terence Joint (21 November 2015)

2. CEO Compliance responsibility ...

Mr Caplin was Martins' chief executive with oversight responsibility for ensuring that Martins' systems and controls and the operation of the business were adequate from a regulatory standpoint. He

- presided over a firm where the **compliance culture was extremely weak**;
- failed to ensure the **timely and adequate implementation** of a compliance recommendation to carry out a risk review;
- failed to ensure the **effective oversight** of the firm's compliance function;
- failed to identify and remedy Martins' **lack of controls** to prevent brokers making or receiving corrupt inducements.

FCA Final Notice: David Caplin (22 January 2015)

3. Executive competence

Ms Sadler failed to exercise due skill care and diligence in managing the business of Aderia for which she was responsible as a Director by **failing to take reasonable steps** to:

- **ensure that appropriate contractual arrangements were in place** for the insurer to provide insurance cover ... before signing binding authority agreements committing Aderia and the insurers to offer that insurance cover; and
- **put in place appropriate systems and controls** to prevent [an unapproved person] taking lead roles in key negotiations on important business transactions and giving instructions to her in relation to Aderia's regulated business, despite the fact that she was the one approved as CF1 (Director(AR)).

FCA Final Notice: Andrea Sadler (1 February 2016)

Chief Executive of Millburn Insurance was fined & prohibited for failing to

- **give sufficient consideration to the risks** resulting from its expansion including risks resulting from its delegation of underwriting authority and its use of reinsurance;
- take reasonable steps to **mitigate an identified risk** in relation to Millburn's reinsurance.
- establish and implement **appropriate systems and controls** to monitor and control the nature of the business that was being underwritten for Millburn; and
- establish and implement **appropriate systems and controls** to ensure that Millburn was able to meet its regulatory obligations in relation to technical provisions, capital, reinsurance and financial reporting ...

PRA Final Notice: Colin McIntosh (1 February 2016)

4. Executive integrity

Mr Alderson ... was knowingly concerned in Co-op Bank's breach of PRIN 3:

... by failing to take reasonable steps to ensure it **adequately assessed the risks** arising from the Britannia Corporate Loan Book

... by not **escalating specific risks** ... to Co-op Bank's board & risk management forums

... by failing to properly identify **sufficiently clear and specific** assessment timescales & metrics

... by failing to ensure that first line of defence took an **adequate approach risk management**,

... by failing to ensure that the **management information** was sufficient to monitor compliance

... staff felt under pressure to meet forecasts [and] this meant that **optimistic decisions were made**

... Mr Alderson ... did not always ensure that impairment budgets and forecasts were set solely by reference to an assessment of the risks

PRA Final Notice: Keith Alderson (14 January 2016)

Mr Tootell was Chief Executive of Co-Operative Bank.

He was **centrally involved in a culture** which prioritised short-term financial gain at the cost of taking prudent and sustainable actions

He did not take adequate steps to ensure that the **Banking Risk team was properly structured and organised** to enable it to provide proper independent challenge and guidance

He was aware that the Corporate Loan Book had been identified as a significant risk to the capital position of the Firm but **did not exercise adequate oversight** in order to ensure that an effective strategy was adequately developed and implemented by the business ...

He did not take adequate steps to ensure that the Board were **fully and adequately briefed about risks** inherent to the business of the Firm

PRA Final Notice: Barry Tootell (14 January 2016)

5. Control function effectiveness

Mr Smith was MLRO and compliance officer at SBUK

- In successive years, and despite the warnings of the Internal Auditors, Mr Smith **failed to put in place compliance monitoring plans** which were appropriately focussed
- Despite suffering from being overworked personally and from a lack of resource in the MLRO department, Mr Smith **failed to impress upon senior management the need for further resources**
- Mr Smith continued throughout the Relevant Period to **reassure the board** and SBUK's senior management that SBUK's AML systems were working effectively.
- Mr Smith did not **take sufficient steps to address the concerns** raised by the Internal Auditors and failed to report adequately the results of internal testing.

FCA Final Notice: Steven Smith (12 October 2016)

Ms Grigg **did not properly understand her responsibilities** as Risk Management Director and failed adequately to identify, manage or control the material risks arising out of the Firms' business model ...

... she **failed to scrutinise appropriately the existing risk management arrangements**, particularly risks to customers;

She **failed to implement an adequate risk management framework** ... because she failed to ensure

- the **Risk Register** adequately identified all material risks
- the **scope and quality of MI** presented to the Board was sufficient, relevant and reliable; and
- the members of the Group Board **understood fully** the Firm's risk exposure by monitoring risk on a proactive and ongoing basis.

FCA Final Notice: Paiivi Grigg (11 December 2015)

So in summary ...

What will happen?

- a) Event occurs
- b) Regulator investigates
- c) Calls for SoR/RM
- d) Identifies responsible individual
- e) Asks
 - “did s/he breach?”
 - “was s/he knowingly concerned?”
 - “is the bank’s breach in his/her area and did s/he take reasonable steps to avoid?”
- f) You need
 - The action
 - The record of ...

What you will need to show ...

- 1. Chief executive**
 - Is *really interested* in all aspects of his or her area
 - Oversees delegates and doesn’t just rely
 - Secures an effective risk function
- 2. Senior manager**
 - Considers and mitigates risks
 - Ensures risks properly managed
 - Puts in place effective mitigations
- 3. Control function**
 - Scrutinises and manages risk
 - Calls for resources when needed

Brexit

The importance of financial services to the UK

	Total	Banking	Asset management	Insurance and reinsurance	Infrastructures and others
UK financial services revenues (GBP bn)	190-205	108-117	20-23	39-42	22-26
UK financial services revenues (% of GDP)	11%	6%	1%	2%	1%
UK financial services revenues related to the EU	23%	22%	26%	10%	44%
UK market shares in the EU	24%	26%	41%	22%-	-

And in words ...

- ... In 2016 the Global Financial Centres Index placed **London once again as the leading global financial centre**, ahead of New-York, Singapore, Hong-Kong and Tokyo [Paris is 29th between Casablanca & Cayman Islands].
- The place of London as a major financial centre **largely predates the single market** ... London ... benefitted from the development of the single market or financial services in the nineties and more recently from the introduction of the single currency in continental Europe.
- Today, **half of the world's financial firms** have based their European headquarters in London, and more than 1 million people work in the financial sector in the UK ... With related professional services (accounting, legal, advisory...), the total amount reaches 2.2 million people. The financial sector earned about GBP 200 billion (11% of GDP) ... about 24% of all EU financial services, and generates about GBP 60 - 67 billion (3.5% of GDP) in UK taxes each year.

European Parliament: Brexit: the United-Kingdom and EU financial services (December 2016)

Not forgetting ...

I would expect that the very strong incentive is for the European Union and the UK to **come to some kind of arrangement**, either very a rapid deal, certainly the sort of narrow transition arrangements, ...

The UK is a **very important provider** of financial services across the European Union, about 24% of value added. Many parts of the European Union's corporate and finance sectors are quite heavily dependent upon their access to the City and this is a time of great vulnerability for them. I would have thought there would be **relatively little appetite on their side to cut themselves off** from access to the City ...

I would guess that we will **probably manage some kind of transitional arrangement** [although] it is very difficult, because of some of the language of punishing the UK and some of the strange allusions that you would make UK City activities migrate to Frankfurt or Paris, which I do not think are very plausible. If you chase them away, they would be **more likely to go to New York or Shanghai** than to go to Frankfurt or Paris ...(Q229)

TSC: Autumn Statement hearing (Dr Lilico QQ 228 & 229) (6 December 2016)

“Brexit means Brexit” ...

- The mandate for Britain to leave the European Union is **clear, overwhelming and unarguable** ... and no one should seek to find ways to **thwart the will of the people** expressed in the referendum on 23 June.
- It is now incumbent on the Government to **deliver an exit in the most orderly and smooth way possible, delivering maximum certainty** for businesses and workers ...
- We will start by bringing forward a great repeal Bill that will mean the **European Communities Act 1972 ceases to apply** on the day we leave the EU.
- We will return sovereignty to the institutions of this United Kingdom ... **all decisions** about taxpayers’ money, borders and laws [will] be taken here in Britain ...
- It demonstrates the Government’s determination to deliver the will of the British people, expressed in the EU referendum result, that **Britain should once again make its own laws for its own people.**

The Secretary of State for Exiting the European Union (Mr David Davis) 10 October 2016

... but what does “Brexit” mean?

The best way to support this Brexit process and make sure that we get the right Brexit for Britain is to give the Prime Minister the maximum space at the negotiating table, within the **two clear constraints** that we have made the **irreversible decision** to leave the European Union and that we are going to **control migration** between the European Union and the United Kingdom. Beyond that, she needs the maximum possible space. (Q35)

Philip Hammond MP, Chancellor of the Exchequer – TSC: The work of the Chancellor of the Exchequer (19 October 2016)

I remain optimistic that there are, at very senior level across the European Union, some **deeply pragmatic people** who have shown by their actions, time and again, that they can find solutions when challenged with problems ... I hope that pragmatism and engagement will deliver us a mutually beneficial solution, because I think it will clearly be in the **interests of the people of all of Europe**, including the UK, if we continue to trade closely together and work closely together, after we have left the European Union. (Q113)

Theresa May's New Year message ...

Dear Simon,

The New Year is a time to reflect on what has passed and to look ahead to the opportunities to come ... we have made a momentous decision and **set ourselves on a new direction** ...

So when I **sit around the negotiating table** in Europe this year, it will be with the knowledge that I am there to get the right deal – not just for those who voted to Leave – but for every single person in this country.

... the referendum **laid bare some further divisions** in our country – between those who are prospering, and those who are not ... those for whom our country works well, and those for whom it does not. This is the year we **need to pull down these barriers** that hold people back, securing a better deal at home for ordinary, working people ...

Theresa May
Prime Minister

We must remember ...

One last word: it is important that we **understand the wider meaning** of the referendum result and respond accordingly. It wasn't just a vote to leave the EU but to **change the way the country works** and the people for whom it works, forever. This is why my government has also embarked on an ambitious programme of economic and social reform to ensure **wealth and opportunity are spread** across the country and everyone is able to share in the success we will make of leaving the EU.

Theresa May, Prime Minister Q5 HC Liaison Cttee 20 December 2016

And now the Government is aiming for ...

1. **Certainty** ... the Government will put the final deal that is agreed between the UK and EU to a vote in both Houses of Parliament.
2. **Control of our own laws** ... we will bring an end to the jurisdiction of the European Court of Justice in Britain.
5. **Control of immigration** ... Brexit must mean control of the number of people who come to Britain from Europe ... there must be control.
6. **Rights for EU nationals in Britain, and British nationals in the EU** ... we can offer EU nationals here this certainty, as long as this is reciprocated for British citizens in EU countries.
8. **Free trade with European markets** ... we will pursue [an] agreement for the freest possible trade in goods and services between Britain and EU member states ...
9. **New trade agreements with other countries:** it is time for Britain to become a global trading nation, striking trade agreements around the world ...
12. **A smooth, orderly Brexit:** we want to have reached an agreement about our future partnership by the time the two year Article 50 process has concluded. From that point onwards, we expect a phased process of implementation. We will work to avoid a disruptive cliff-edge.

Theresa May, Prime Minister 17 January 2017

Brexit for financial institutions

... the reality is that **financial services remains our single largest sector**. It is responsible for a very large number of jobs spread across the United Kingdom ... The industry knows that we regard it as extremely important. The industry knows that we understand that it has a particular set of challenges ... I hope the industry knows ... that helping to address those challenges and take account of those challenges will be a **very high priority** for the Government. (Q58)

We are very much aware that [passporting] would be the financial services sector's first preference, but we are also **acutely aware of the challenges** of delivering it. (Q68)

Philip Hammond MP, Chancellor of the Exchequer – TSC: The work of the Chancellor of the Exchequer (19 October 2016)

Or, put another way ...

We want the very best deal for financial services – 2.2 million people, £67 billion in tax income. You've told us, for example, about the importance of market access for this industry. We know that if the UK is to have a passporting regime, that we will need a **regulatory regime that is comparable and well-harmonised** with the countries into which we are passporting.

You've also told us you're **worried about market disruption** and the risks to financial stability when we leave the EU. And so we will push for a solution that means an orderly transition – that neither disrupts how financial services are delivered, nor importantly drives up costs.

... let me end with three promises to you here today.

1. We are going to keep on doing what it takes to see the UK's financial services industry remain a **world leader**.
2. We are going to keep on making this a country which is **competitive and open** for business.
3. The government will keep fighting to **get the best possible deal** for British business, and make Brexit a success.

HMT: Speech by Simon Kirby (Economic Secretary to the Treasury) (11 October 2016)

What's the target model?

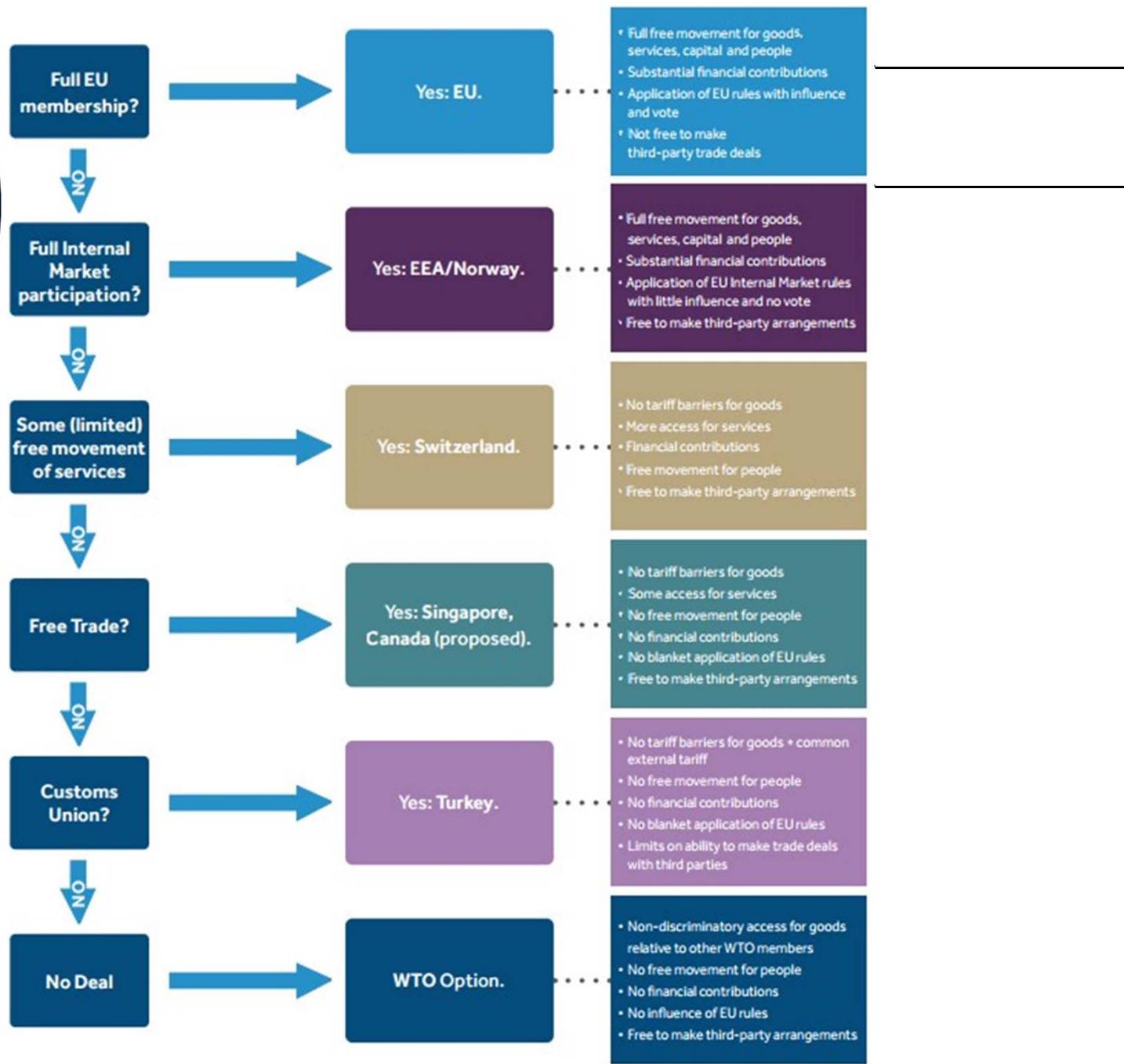
Our vision for Britain outside the EU is clear: a fully independent, sovereign country. We are **not looking for an 'off the shelf' deal** for our future relationship – a Norwegian model or a Swiss model – it's going to be an agreement between an independent, sovereign UK and the EU. We want that relationship to reflect the kind of mature, cooperative relationship that close friends and allies enjoy

**Department for Exiting the EU: FAQ
(22 November 2016)**

So the ingredients are . . .

- Replicating passporting?
- Securing equivalence?
- A transitional period?
- Or DIY?

Six off-the-shelf Brexit models we don't want



The ideal Brexit for financial institutions

- a) Cross-border market access.
- b) Support for the principle of consistent global standards where markets are also global.
- c) Cooperation between regulatory authorities.
- d) Influence over standards.
- e) Opportunity to recruit and maintain a skilled workforce.

FCA letter to Treasury Committee 28 October 2016

Will there be a transition?

... we are very supportive of the concept of **securing transitional arrangements** so that the necessary negotiations ... can be carried out [but] Article 50 was designed with exactly the opposite set of objectives in mind – to impose and enforce such a reduced timeline to raise the cost of exiting the EU and make it punitive, or to create a level of uncertainty

Xavier Rolet Chief Executive, London Stock Exchange Group. HoL EU Financial Affairs Sub-Committee: Brexit and financial services in the UK (2 November 2016)

We recognise the **need for a smooth transition** which minimises disruption to our trading relationships, including with developing countries ...

Department for Exiting the EU: FAQ (22 November 2016)

Timetable ...

- March 2017 – Article 50 notification
- March 2019 – UK = 3rd state
- Possibly transition?
- Possibly uncertainty of outcome persists?

The importance of clarity

... there [are] **three parts to this**: how we exit, what comes thereafter and how we transition from one to the other. We have to have a **greater amount of, frankly, understanding** all three of them.

... if you take off in a plane it is **quite useful to know where you are going to land** ...

TSC: Andrew Bailey replies to QQ 46, 51 & 57 FCA (8 November 2016)

The importance of certainty

However, the primary cause of potential instability or migration of business would come ... if our customers are **faced with an uncertain outcome** within, say, the next two and a half years, for the protection of their own customers and shareholders they likely have to start today to think, plan and execute alternative arrangements ...

For most financial securities and licences, the **delays in securing a licence easily exceed a year; 18 to 24 months** is the norm, particularly since in most cases the regulatory environment in Europe is less global, sophisticated and deep than it is in the UK. So the ability to process multiple applications takes time. This is the issue that financial services participants face in the UK: customer behaviour today is **forced by the very short timeline that you referred to and the necessity to plan for the very worst outcome** ...

HoL EU Financial Affairs Sub-Committee: Brexit and financial services in the UK (Mr Xavier Rolet KBE, Chief Executive, London Stock Exchange Group) (2 November 2016)

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Will there be passporting?

Passporting is ... **very important** to maintain the predictability of an operational environment that reassures our clients that they can continue to do their business in the way that they have for the past few years with us right here in the UK, without the need for taking alternative measures ...

Xavier Rolet Chief Executive, London Stock Exchange Group. HoL EU Financial Affairs Sub-Committee: Brexit and financial services in the UK (2 November 2016)

Will we remain a member of the Single Market?

As the Prime Minister said: **we want British companies to have the maximum freedom** to trade with and operate in the Single Market – and to let European businesses do the same here.

Department for Exiting the EU: FAQ (22 November 2016)

The UK favours the *Wimbledon* model of free market access.

Passporting – will it work?

- Passport = mutual recognition of authorisation so re-authorisation not required.
- Passporting regime is
 - Limited in scope – principally institutional & wholesale
 - Does not map well against business lines
 - May be non-existent (retail finance; payments; banking)
 - EU firm relies on general TFEU freedom subject local laws
 - Few third-country passporting regimes
 - And they don't apply for retail business
- If not, firm needs specific permissions to operate cross-border.

And equivalence ... ?

- A 3rd country can ask for equivalence in a specific field
- If the Directive/Regulation provides for it
- And the Commission agrees the home regime is equivalent
 - Legislation
 - Supervision
 - Market access
- May then grant *limited* market access
 - MiFIR to service professional clients
 - SII for reinsurance
 - EMIR for CCPs
 - AIFMD for non-UCITS
- But may be more limited benefits – for example under CRD IV equivalence = permitted risk weighting

European Parliament: Third-country equivalence in EU banking legislation (November 2016)

Without passporting or equivalence

The UK will try to seek bespoke equivalence

- Otherwise politically unacceptable
- Also commercially unacceptable
- Results in denial of markets
- Parallel regimes
 - Risk to market integrity
 - Less choice for consumers

But it may not get it – and will not get it within two years

The DIY Brexit toolkit – a new business model

- Have an EU subsidiary
- Perform permission review
 - Is there a passporting gap?
- Transfer UK services
 - Transferring the front office
 - The back office is perhaps already there
 - Redomicile the fund
- The need for solidity

Not forgetting ...

- 1) You're in another country!
- 2) Quality of regulation
- 3) Costs of subsidiarisation
- 4) Loss of deep pool
- 5) Customer acceptability
- 6) Taxation
- 7) Employment
- 8) IT
- 9) Contract law
- 10) Selling elsewhere – UK included

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