LATHAM & WATKINS

13 May 2020

Financial Regulation Monthly Breakfast Webinar

Overview

- The FCA's Dear CEO letter on bank lending and capital markets
- The FCA's actions to clarify business disruption terms in insurance contracts
- The latest Brexit updates including the extension of the regulators' temporary transitional powers
- ESG transition: Latest updates from the EU (including Low Carbon Benchmarks)
- ESMA's MiFID papers on inducements and costs and charges disclosures, and the transparency regime for non-equity instruments

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The FCA’s Dear CEO letter on bank lending and capital markets

Rob Moulton

Dear CEO letter on equity corporate finance

- Background of helpful FCA statements related to COVID-19
  - Delay to financial statements
  - Pre-emption right waivers when raising finance
  - Useful ability to make qualifications in financial statements
- Mirrored in
  - Guidance on operational measures
  - ESMA’s equivalent pronouncements

28 April Dear CEO letter – highlights

- “Lending banks may have used their lending relationships to exert pressure on corporate clients to secure roles on equity mandates that the issuer would not otherwise appoint them to”
- “Role may be in name only, with few or no additional services being provided”
- This is “not in the best interest of those clients, distorts competition, undermines market confidence and calls into question firms’ and individuals’ integrity”

Potential breaches

- PRIN
  - 1, integrity
  - 5, proper standards of market conduct
- COBS
  - 2.1, clients’ best interests
  - 11A.2, tie-ins to future business
- SYSC
  - 10.1, conflicts of interest
  - SM&CR

Lessons?

- The FCA is not a one-way street on COVID-19
- Did the future business tie-in rule really sink in? (Thematic review?)
- The FCA is as politically/press motivated as ever
- Every problem is an SM&CR problem
- MAR remains on their radar
    - The FCA points out that information cannot generally be shared on the private side (Thematic review? Again?)

FCA's comments on Boris Johnson's statement

- It doesn't change anything

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The FCA's actions to clarify business disruption terms in insurance contracts

Victoria Sander

FCA action on Business Interruption Insurance

Background to FCA intervention

- Business interruption insurance issues in light of Government advice and lockdown
- Industry response that most business interruption policies would not cover pandemic related losses

Regulatory reaction to the industry response

- FCA expectations of insurers published on 19 March
- Dear CEO letter of 15 April acknowledged that most business interruption policies unlikely to respond to pandemics
- Swift payment for those with pandemic cover including interim payments
- Continued emphasis on fair outcomes for customers and firm culture

FCA action on Business Interruption Insurance

FCA action for declaratory judgments

- Increased litigation has emerged including class actions
- FCA announcement on 1 May of intention to bring action for declaratory judgments on interpretation of sample policy wordings causing the greatest uncertainty over liability
- Statement references SMEs – but could impact all policyholders
- Engagement with insurers is ongoing but expected they will be added as parties by agreement
- Hearing potentially as early as July?

Greater certainty?

- Association of British Insurers and British Insurance Brokers Association have welcomed the action
- Insurers are co-operating but may now wish to delay decisions until the judgment
- Policyholders not prevented from bringing individual actions
- Role of the Financial Ombudsman Service
- Potential for mis-selling claims
- Possibility of appeal

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The latest Brexit updates including the extension of the regulators' temporary transitional powers

Anne Mainwaring

Regulators’ Temporary Transitional Power (TTP)

- On 25 March it was confirmed that the regulators’ TTP will be retained and its application extended such that it is available for use by the UK regulators for a period of 2 years from the end of the transition period
- The purpose of the TTP is to allow the Bank of England, the PRA and the FCA to phase-in changes to UK regulatory requirements so that firms can adjust to the UK’s post-transition period regime in an orderly way
- The Bank of England, the PRA and the FCA intend to grant general transitional relief on a broad basis for a period of 15 months after the end of the transition period (i.e. ending on Thursday, 31 March 2022)

What does the extension of the TTP mean for firms?

- “This means that regulatory obligations on firms will generally remain the same as they were before the end of the transition period for that temporary period. It also means that, generally, UK regulated firms will not need to complete preparations to implement changes in UK law arising from the end of the transition period by December 2020”
- Note however:
    - Transitional relief will not be granted in all areas – where relief is not granted the regulators expect firms to take reasonable steps to comply with the changes to their regulatory obligations by the end of the transition period (i.e. by the end of this year)
    - Changes in scope and definitions
    - Interaction with other transitional measures

FCA's national and international response to Brexit

- There are some Brexit related risks which need multilateral or reciprocal action and which are not within the FCA's remit to address alone:
  - Issues that could be resolved through reciprocal equivalence (such as the overlapping UK and EU share and derivatives trading obligations); and
  - Issues that cannot be resolved through equivalence, including broader contract continuity issues and the continued provision of retail financial services by UK firms to EU consumers

FCA’s national and international response to Brexit

- Whilst the FCA has put in place transitional regimes for EEA firms, the situation for UK firms in the EU is not the same. Their continued operations after the end of the transition period will depend on the regulatory regimes of individual EU member states. Whilst many of these member states had put in place temporary transitional regimes in the event of a ‘no-deal’ exit, the majority of these have now lapsed
- Firms should continue to consider what actions they need to take to be ready for the end of the transition period, and what this will mean for their customers

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ESG transition: Latest updates from the EU (including Low Carbon Benchmarks)

Nicola Higgs

ESG reform agenda

Timeline of Key EU Reform Milestones

Governance & Prudential

Oct 2019
UK banks must have an initial plan to address the PRA expectations on financial risk management and submit an SMF form

31 Dec 2021
Companies: Disclosures for activities related to all environmental objectives (covering financial year 2021, publication in the course of 2022)

31 Dec 2022
Companies: Disclosures for activities related to all environmental objectives (covering financial year 2022, publication in the course of 2023)

Taxonomy

31 Dec 2020
Technical screening criteria for climate change mitigation and adaption

1 June 2021
Companies: Delegated Acts - Disclosure obligations

31 Dec 2021
Technical screening criteria for other climate objectives

31 Dec 2022
Financial market participants: Disclosures in relation to environmental objectives (periodic reports, pre-contractual disclosures and websites)

Disclosure Regulation

29 Dec 2019
Parts of Regulation apply

10 Mar 2021
Majority of Regulation applies

30 Jun 2021
Website Disclosures

31 Dec 2021
RTS due

1 Jan 2022
Enhanced pre-contractual disclosures

Benchmark Regulation

30 Apr 2020
Disclosure and review obligations for ESG and non-ESG benchmarks

1 Jan 2021
Excluded sectors for Paris aligned benchmarks to be finalised

31 Dec 2021
Enhanced disclosures for non-ESG benchmarks

31 Dec 2022
Constituents criteria for Paris aligned benchmarks

1 Jan 2022
'Significant' benchmark administrators must provide climate transition benchmark(s)

MiFID II ESG Amends

Q1 2021
Expected application date

2019 | 2020 | 2021 | 2022

Key obligations of financial institutions

Corporate level obligations

Corporate strategies		1. Corporates are undertaking wholesale ESG reviews 2. Consider the need to update regulatory bodies: (i) new business / product lines; (ii) a failure to keep pace with sustainability transition 3. Associated risks: (i) making commitments on an ESG corporate strategy that are unrealistic / uninformed; and (ii) commitments giving rise to liability concerns for acts of subsidiaries and investee companies
Board oversight	Task Force	Consider establishing a sustainability task force to coordinate all of the global teams and committees impacted by transition
	Fiduciary Duty	Adequately taking into account ESG matters in taking decisions may be a fiduciary obligation (directors / institutional investors)
	UK SMCR	Requirement to appoint SMF and update SOR
Risk	Enterprise Risk Framework	Set risk appetite from the physical and transition risks of sustainable finance and manage, monitor (using qualitative and quantitative tools and metrics) and mitigate risks appropriately
	ICAAP	Include: (i) all material exposures relating to the financial risks; (ii) an assessment of how the material exposure(s) are determined in the context of the relevant business
	Scenario Analysis	Address a range of successful transition / non-successful transition outcomes both short and long term given the unpredictability of the outcomes
Company	Disclosure	**1.** **TCFD** – Consistent climate related financial risk disclosures for use by companies in providing information to stakeholders 2. UN Sustainable Stock Exchanges Initiative (**SSE**) - recommendations on ESG disclosures for listed companies 3. Establish rigorous mechanisms to validate the accuracy of the information disclosed. E.g. independent auditing
	Investors	Seeing an increasingly activist approach from shareholders
Incentives		Requirement to consider how incentives support or conflict with corporate strategy on sustainability

Business line impact

Taxonomy Regulation	Corporates: Financial and non-financial Products: UCITS, AIFs, pensions, insurance based investment products, pan-European investment products, securitisation funds, venture capital and private equity funds, index funds, portfolio management
Green Bond Standard	Bonds
Social bonds	Bonds
Listed issuers	Equities
Low Carbon Benchmarks	Indices falling within scope of the EU benchmark regulation
Disclosure Regulation	UCITS, AIFs, pensions, insurance based investment products, portfolio management
MiFID II	Investment advice and portfolio management
Securitisations	

ESG benchmarks

Entity scope	Benchmark Administrators providing benchmarks in the EU and EU Users of Benchmarks Note: Impact on third country administrators of benchmarks
Product scope	Financial products that ‘use’ benchmarks in scope of EU Benchmark Regulation Excluded: Interest rate and forex benchmarks
Impact	Three new categories of ESG benchmarks, which administrators are eligible to market only after they have ensured compliance with certain criteria: • EU climate transition benchmarks (CTB): benchmarks should be determined as taking into account companies in the investment portfolio that follow a measurable science-based “decarbonisation trajectory” by end-2022, in light of the long term global warming target of the Paris Climate Agreement • EU Paris-aligned benchmarks (PAB): which have the more ambitious goal to select only companies in the investment portfolio that contribute to achieving the 2ºC reduction in global average temperature set out in the Paris Agreement • Benchmarks pursuing ESG objectives: This term is not defined but captures all other ESG benchmarks that do not aim to meet the strict criteria of CTB and PAB

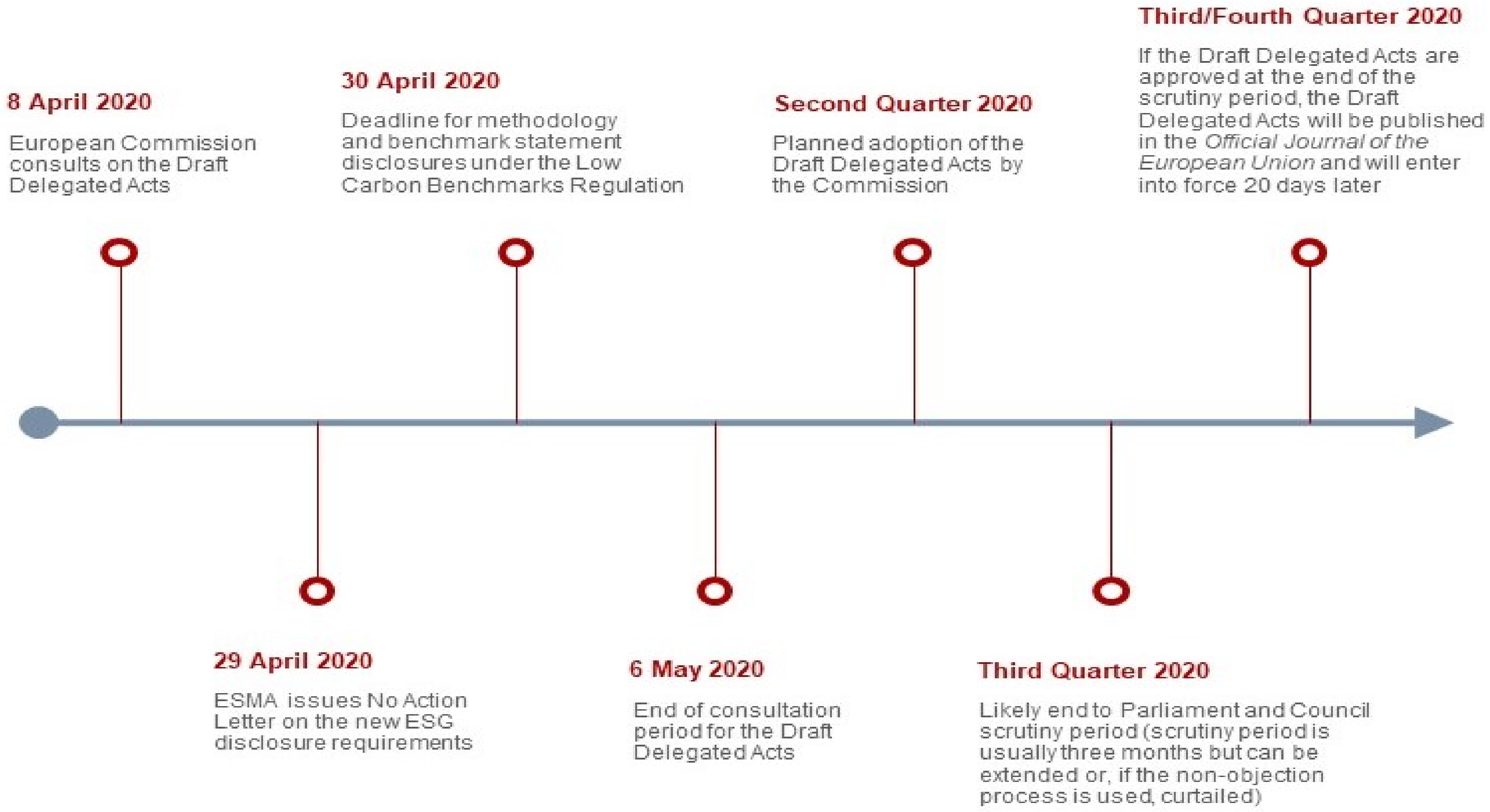
Timing	30 April 2020*
	*Note: ESMA no action letter pending implementation of the Delegated Acts
	• ESG benchmarks (inc. CTB & PAB) –
	    • Methodology – An explanation of how the key elements of the methodology reflect ESG factors for each benchmark or each family of benchmarks
	    • Benchmark statements – An explanation of how ESG factors are reflected in each benchmark or each family of benchmarks
	• Non-ESG benchmarks
	    • Benchmark statement to state that the index does not pursue ESG objectives
	• Where an individual administrator has no benchmarks that pursue ESG objectives, this needs to be stated in all benchmark statements produced by the administrator
	Note: Further developments in relation to PAB (excluded constituent sectors) and CTB (additional criteria for the selection of constituents) will be implemented in the coming years

ESG benchmarks – delegated acts

- ESG Disclosures
  - Key point: the required ESG disclosures differ depending on the asset class of the index
  - ESG Ratings – Ultimately, benchmarks are likely to have overall ESG ratings (when the Sustainable Finance Action Plan is more evolved). However, the inclusion of such ratings remains voluntary for the time being
  - Selecting the relevant template:

Benchmark type
Equity
Fixed Income Corporate (corporate credit bonds, corporate asset backed securities and money market instruments)
Sovereign debt
Commodity
Private equity and private debt
Other

ESG benchmarks – delegated acts



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ESMA's MiFID papers on inducements and costs and charges disclosures, and the transparency regime for non-equity instruments

Gabriel Lakeman

Overview

- ESMA has recently released several papers on MiFID II/MiFIR, including:
  - Final Report: Technical Advice to the Commission on the impact of the inducements and costs and charges disclosure requirements under MiFID II
  - Consultation Paper: MiFID II/MiFIR review report on the transparency regime for non-equity instruments and the trading obligation for derivatives
- Both are published in the context of the Commission's public consultation on MiFID II (the "MiFID refit")

ESMA technical advice on inducements

- "[T]*he MiFID inducement disclosure rules have not had the positive impact expected*"

- Key legislative recommendations:
  - Inducements disclosures (*ex-ante and ex-post*) should be made on an ISIN-by-ISIN basis
  - Firms should include a simple and clear explanation of the terms used to refer to inducements (e.g. *"third-party payments"*), particularly for retail clients
  - Where fees, commissions or non-monetary benefits are justified on the basis of quality enhancement, the specific quality enhancing services must be disclosed to the clients who do, or could, benefit from them

ESMA technical advice on inducements

Additional points:

- ESMA rejects creation of a new category of *“sophisticated retail clients”* for the purposes of the inducements regime
- ESMA confirms its view that placing and underwriting fees should be disclosed under the inducements regime when the firm is providing a service to the investor
- ESMA rejects introducing a complete EU-wide ban on inducements under MiFID II, but suggests the Commission carries out an impact assessment on such a ban (including by reference to the current UK retail-focused restrictions)
- ESMA suggests further analysis should be conducted on investor protection issues arising in closed-architecture distribution models

ESMA technical advice on costs and charges

- The MiFID costs and charges regime *"has proven effective"*, but *"should allow for more flexibility when applied to eligible counterparties and professional clients"*

- Key legislative recommendations
  - Eligible counterparties should be allowed to opt-out of the entire costs and charges disclosure regime (ex-ante and ex-post)
  - Professional clients (per se and elective) should also be allowed to opt-out, other than in respect of investment advice and portfolio management
  - Various amendments should be made to the existing regime, including, amongst others, (a) incorporation of certain ESMA Q&A into legislation, (b) clarification on timings for provision of ex-ante disclosures in telephone trading contexts, and (c) in relation to provision of information by means of electronic communication

ESMA technical advice on costs and charges

Additional points:

- ESMA again rejects the introduction of a category of *“sophisticated retail clients”*
- ESMA recognises need to align the MiFID regime with the PRIIPs framework, but this should be considered after the current European Supervisory Authorities PRIIPS review
- ESMA views implicit costs, including implicit transaction costs, as requiring disclosure – but defers further consideration of transaction costs methodology until the outcome of the PRIIPs review

ESMA review report on non-equity transparency

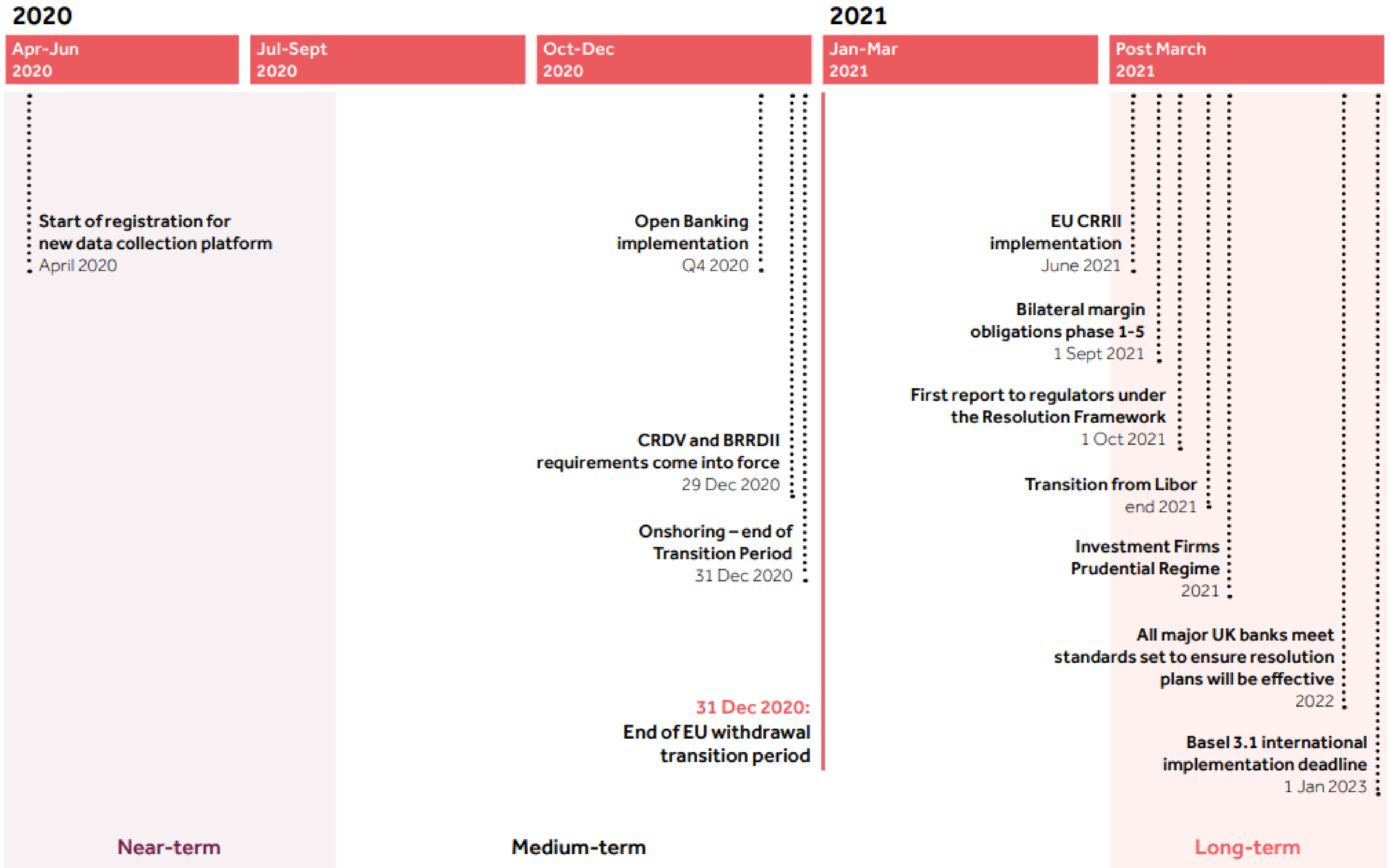
- Publication follows ESMA’s consultation papers on the equity regime and on non-equity systematic internalisers
- Focus is on (a) the pre-trade transparency regime for trading venues, (b) the post-trade transparency regime, (c) the trading obligation for derivatives, and (d) level 2 regulatory technical standards (in particular RTS 2)

ESMA review report on non-equity transparency

- Selected points:
  - Levels of pre-trade transparency in non-equity markets are limited, and ESMA is proposing to simplify the regime by limiting waivers
  - ESMA views the post-trade transparency regime as providing data of limited use, and is proposing creating a uniform deferral regime
  - ESMA is consulting on revisiting the concept of *“traded on a trading venue”* to broaden the extent to which OTC derivatives are subject to trade and transaction reporting requirements

- Consultation now closes 14 June 2020

Key initiatives in the regulatory landscape



- The Financial Services Regulatory Initiatives Forum has published a new Regulatory Initiatives Grid
- The Grid sets out the planned regulatory workplan over the next twelve months
- The full document can be found here

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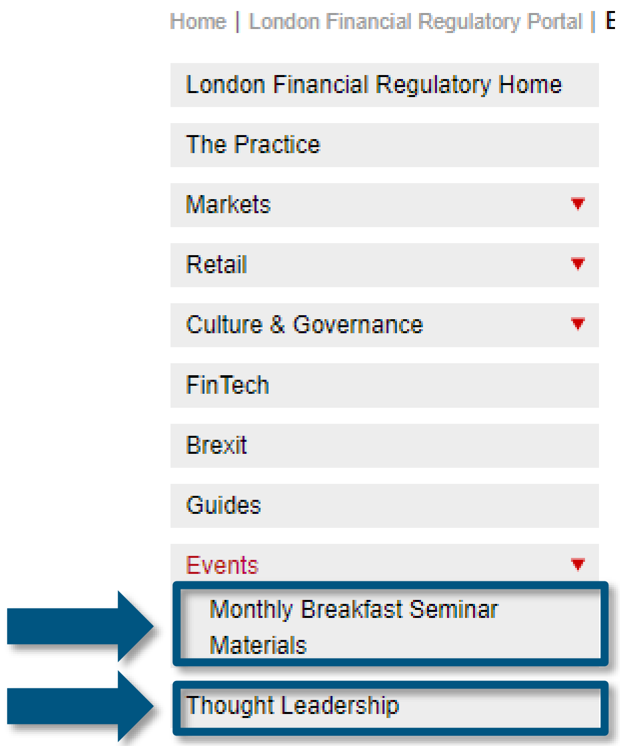

[LIBOR Transition Focus Areas in 2020]

[European Commission Publishes Draft Delegated Regulations on ESG Disclosures in Benchmarks]

[COVID-19: FCA Delays Implementation of SCA Under PSRs 2017]

[FCA to Apply for Court Declaration on Business Interruption Insurance Policies]

[Navigating Debt Repurchases in Europe: What You Need to Know]

[World Economic Forum Launches First-of-Its-Kind Blockchain Deployment Toolkit]

[FCA Announces Additional Primary Market Measures to Support Listed Companies]

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