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9 September 2020

Financial Regulation Monthly Breakfast Webcast

Overview

- FCA's 5 Conduct Questions – 2020 report
- European Commission's MiFID II COVID-19 amendment proposals
- FCA's Dear CEO letters on TTCA and client money
- The impact in the UK of the Hong Kong Autonomy Act
- ESMA's recommendations on the review of the AIFMD



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FCA's 5 Conduct Questions – 2020 report
David Berman

5 Conduct Questions Programme: Industry Feedback for 2019/20

- Conduct and culture remains a key focus for the FCA
- Newly-published annual feedback report “*Messages From the Engine Room*” reflects the FCA’s findings, perspectives and views following a series of conduct roundtables
 - Participants in exercise were V-P level personnel
- Relevant to all firms across the financial services spectrum
- See Chapter 8 of our Culture Framework for a consolidation of the key points arising from feedback reports from previous years

Key findings: Identification of conduct

- Depth of understanding and ability to identify conduct risk in day-to-day working life remains unacceptably weak
- An active approach to identifying conduct risk is an essential first step for firms
- A more sophisticated and deeper focus on conduct risk training and identification is expected by the FCA

Key findings: Remuneration and performance assessments

- Insufficient steps have been taken to “*ensure substantive feedback discussions with staff, keep future-oriented records, analyse trends and develop a governance feedback loop*”
- Importance of providing meaningful feedback referenced throughout the report
- Transparency around promotion decisions “has become a clear staff expectation”
- Trend analyses can help to monitor direction of travel over time and identify any potential troubling themes

Key findings: Culture, safety and leadership

- Persistent and significant lack of psychological safety in day-to-day speak up and challenge
 - Lack of action and/or meaningful updates
- Closer alignment of shareholder, client and employee interests as well as other stakeholders is expected
- Managers at all levels are expected to demonstrate consistent degree of empathy, self-reflection, self-awareness, diplomacy and civility expected
 - Lack of such attributes can lead to “toxic” cultures
 - Behavioural training for managers

Key findings: Purpose, principles and values

- Improving clarity of purpose (and values) is essential
 - Both corporate and individual purpose
- “Tone from within” (*i.e.* one’s individual mindset, preferences, beliefs, habits and pre-dispositions) – an important new operative phrase
 - “Moral dilemma” scenarios
 - Training, self-reflection and self-challenge

A blue-toned background featuring a financial line chart with a grid. The chart shows two data series: a solid blue line and a dotted blue line. The solid line starts high on the left, dips, rises, dips again, and then rises sharply towards the right. The dotted line starts high, dips, and then trends downwards. The overall aesthetic is professional and data-oriented.

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European Commission's MiFID II COVID-19
amendment proposals
Rob Moulton

European Commission's MiFID II proposals – overview

- Two proposed new directives
 - First one amends MiFID II
 - Second one amends the Research Delegated Directive
- Stated aim – “*help the recovery from the COVID-19 pandemic*”
- Key objectives
 - Facilitating investments in the real economy
 - Allowing for a rapid recapitalisation of European companies

Costs and charges

- *“Professional clients, eligible counterparties and ESMA have unanimously and repeatedly told the Commission that these [costs and charges] requirements have no benefit where other services than portfolio management and investment advice are concerned”*
- *“Cutting red tape has become even more urgent...the COVID-19 pandemic has accelerated the usage of electronic investment services”*
- Fee disclosures
 - Unchanged for retail
 - Unchanged for investment advice and asset management
 - In all other cases, basic requirements on clarity around actual costs and charges are the key remaining requirements
- Annual cost reports, and 10% loss reports, no longer required for eligible counterparties, although professionals can still opt-in

Product governance

- *“Product governance rules for certain instruments...have prevented an optimal allocation of capital by means of vibrant secondary markets”*
- Exemption for “plain vanilla” corporate bonds, even if they include a make-whole clause, from the Product Governance regime (and – hopefully PRIIPs)

Best execution

- *“Stakeholders indicate that the [RTS 27] reports are rarely read by investors...the current crisis has increased the urgency to address problems with regard to the costly production of best execution reports”*
- RTS 27 suspended pending MiFID II review in 2021

Research

- *“The exceptional circumstances resulting from the COVID-19 pandemic have instilled a sense of urgency into the debate on small and mid-cap issuers and fixed income instruments”*
- Exemption from unbundling for research “exclusively” on small and mid-cap issuers
 - Market cap of less than EUR 1 billion in previous 12 months
 - Reference to “dedicated small and mid-cap trading desks”
 - Exemption for research “exclusively” on fixed income instruments
 - Managers must tell clients before re-bundling

Brexit

- Will the UK follow suit?

Market Watch 65

- Emphasises need for confidentiality in information requests
 - Example of a Compliance Team contacting the Deal Team to help collate information on unauthorised access, leading to the suspect resigning and leaving the country
- If the FCA consents to sharing information outside Compliance, emphasises ongoing duty of confidentiality
- The FCA requests firms do not unnecessarily disclose information subject to Legal Professional Privilege
- Additional transaction reporting guidance on trading venue codes, country of branch fields, which underlying instrument to report



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FCA's Dear CEO letters on TTCA and client money
Gabriel Lakeman

Overview and background

- Two recent “Dear CEO” letters:
 - Inappropriate use of title transfer collateral arrangements (TTCAs) and regulatory permissions for financing transactions – 24 July 2020
 - Increased client money balances since COVID-19 – 12 August 2020
- Background:
 - CASS a continued area of focus for the FCA
 - Use of TTCAs has received increasing attention from regulators
 - FCA has emphasised the need to ensure continued CASS compliance, notwithstanding the impact of the COVID-19 pandemic

Title transfer collateral arrangements

- Title Transfer Collateral Arrangements – *“arrangements by which clients transfer full ownership of [safe custody assets or money] to the firm for the purposes of securing or otherwise covering present or future, actual, contingent or prospective obligations”*
- FCA focused on:
 - Inappropriate use of TTCAs
 - Incorrect regulatory classification of financing transactions relating to assets subject to TTCAs, for the purposes of prudential classifications

Inappropriate use of TTCA

- Use of TTCAs is subject to multiple regulatory requirements:
 - Documentation requirements
 - Requirements to consider the use of TTCAs in the context of clients' obligations to firms
 - Requirements relating to termination of TTCAs
- As a result of recent supervisory activity, the FCA has identified multiple cases of inappropriate use of TTCAs
- FCA is therefore asking firms to review their use of TTCAs in light of these requirements

Financing transactions and prudential classifications

- FCA/CRD-derived prudential requirements contain a “matched principal exemption” (MPE), under which firms may engage in matched principal trading without counting as “dealing on own account” for prudential classificatory purposes
- FCA has identified firms relying on this exemption to enter into financing transactions in relation to assets subject to TTCAs
- FCA now expressing its view that such activity is not consistent with the MPE, and is requiring firms to review their use of the MPE in light of their regulatory permissions

Next steps and observations

- Next steps:
 - Firms already required to confirm they are considering the issues (14 August 2020)
 - Firms should now be in the process of reviewing/completing their reviews
 - FCA has emphasised the need to report rule breaches to the regulator
- Additional observations:
 - Continued focus on individual accountability – the FCA is requiring confirmations from specific Senior Managers, and potential board-level attention
 - On prudential side, indications are that the MPE is not likely to be retained under new prudential regime for investment firms

Increased client money balances

- FCA has noticed reported increased client money balances during H1 2020
- FCA is requesting firms providing non-discretionary investment services to consider such client money balances, and potentially return balances to clients where they are unlikely to be reinvested in the short term
- Additional observations:
 - Again, FCA explicitly focusing on relevant Senior Managers and individual accountability
 - FCA is demonstrating its continued monitoring of CASS reporting and ability to intervene



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The impact in the UK of the Hong Kong Autonomy Act
Simon Hawkins

National Security Law
implemented into the
Hong Kong Basic Law



Hong Kong Autonomy
Act of 2020 enacted by
US Congress

Hong Kong Autonomy Act

The Hong Kong Autonomy Act mandates sanctions on:

- **Foreign persons** the Secretary of State, in consultation with the Secretary of the Treasury, determines are materially contributing to, have materially contributed to, or that attempt to materially contribute to *“the failure of the Government of China to meet its obligations under the Joint Declaration or the Basic Law”*
- **Foreign financial institutions** the Secretary of the Treasury, in consultation with the Secretary of State, identifies *“that knowingly conduct a significant transaction”* with such foreign persons
- These determinations will be made in **two separate reports** to Congress, updated annually

Hong Kong Autonomy Act

- Within 90 days of the Act's enactment (by 12 October 2020), the State Department must submit a report to Congress that identifies **foreign persons** determined to be “*materially contributing*”, or attempting to materially contribute, to any failure of the Chinese Government to comply with the Sino-British Joint Declaration or the Hong Kong Basic Law
- Sanctions must be imposed on those listed in the report within one year of inclusion in the report. Sanctions include:
 - Prohibitions on property transactions
 - Exclusion from the United States and revocation of visa
- Also note that the Executive Order on Hong Kong Normalization (E.O. 13936) requires asset blocking against certain designated persons and to date 11 HK/Chinese politicians and members of the HK police force have been designated

Hong Kong Autonomy Act

- Between 30 and 60 days following the submission of the first report (by 11 December 2020), the Treasury Department must submit a report to Congress that identifies any foreign financial institutions determined to have knowingly conducted a “*significant transaction*” with foreign persons identified in the first report

Hong Kong Autonomy Act

- At least five of the following sanctions must be applied within one year of financial institution inclusion on the report; all ten must be applied within two years. Sanctions include prohibitions, restrictions, or bans on:
 - Loans from U.S. financial institutions
 - Designation as primary dealer in USG debt instruments
 - Service as a repository for USG funds
 - Foreign exchange transactions
 - Banking transactions
 - Property transactions
 - Exports, reexports, and transfers
 - Investment in equity or debt
 - Exclusion of corporate officers, principals, shareholders from U.S.
 - Imposition of sanctions on Principal Executive Officers

Impact on UK financial institutions

- Monitor for forthcoming developments, notably the report identifying the relevant “foreign persons” that will be submitted to Congress on or before 12 October 2020 and the subsequent report identifying the relevant “foreign financial institutions”
- Consider risk of doing business with any of the designated foreign persons in light of consequences of being designated as a foreign financial institution under the Hong Kong Autonomy Act
- Ensure that compliance procedures are sufficiently robust to detect relationships/potential relationships with designated foreign persons and those persons who have already been designated under the Executive Order on Hong Kong Normalization



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ESMA's recommendations on the review of the
AIFMD
Becky Critchley

ESMA's recommendations on the review of the AIFMD

- On 18 August 2020, ESMA wrote to the European Commission highlighting areas to consider during its review of the AIFMD
- Follows the European Commission's Report on the AIFMD published on 10 June 2020
- Based on ESMA and NCA's practical experience gathered since 2011 where they have "*identified areas that could be improved in the legislation to enhance the supervision of alternative fund managers in Europe*"
- ESMA has encouraged the European Commission to support the areas identified in the letter "*in order to improve the effectiveness and soundness of the AIFMD*"

ESMA's recommendations on the review of the AIFMD

- ESMA's letter includes in Annex 1 recommendations for changes in 19 areas of the AIFMD, including:
 - Harmonising the AIFMD and UCITS regimes
 - Clarifications regarding the scope of additional MiFID services and when firms are within MiFID portfolio management or within AIFMD / UCITS
 - Rule avoidance?
 - Delegation
 - Extent of delegation
 - Regulatory arbitrage
 - Secondment arrangements
 - White labelling
 - Reverse solicitation
 - The harmonisation of supervision of cross-border entities, activities and branches
 - A specific framework for loan origination
 - Amendments to leverage calculations to ensure alignment with the IOSCO framework
 - Reporting issues - Annex II is dedicated specifically to key reporting issues

Outsourcing: Guidance on the Legal and Regulatory Framework

We have partnered with **AFME**, Matheson and BSP to develop: Outsourcing – Guidance on the Legal and Regulatory Framework, a pioneering resource examining the key European legislation, rules, and guidance for financial services firms to consider in relation to outsourcing.

[To access the framework please click here.](#)



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[SEC Expands the Definitions of AI and QIB](#)

[SMCR: FCA Updates Expectations on Fitness and Propriety Assessments and Conduct Rules Training](#)

[HM Treasury Policy Statement Addresses Pressing Concerns With PRIIPs Regulation](#)

[European Commission Proposes Changes to MiFID II Due to COVID-19](#)

[FCA Issues New Safeguarding Guidance for Payment and E-Money Firms Amid COVID-19](#)

[UK Government Proposes to Strengthen Protections Around Promotion of Financial Products and Cryptoassets](#)
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[UK Government Launches Major Independent Review of UK Fintech Sector](#)

[Dear CEO: UK Banks and Insurers Should Embed Approaches to Managing Climate Change Risks by End-2021](#)

