LATHAM & WATKINS

10 Key Regulatory Focus Areas

for UK/European Wholesale Markets in 2020

Regulatory Focus Areas

In last year's publication and in our mid-year progress report, we highlighted the top regulatory focus areas for our clients during 2019, concentrating on wholesale market structures and conduct risk.

This publication outlines the primary focus areas we are seeing for 2020. These topics are attracting particular attention because they are an emerging trend, they are at a key stage in the regulatory change or implementation cycle, or because uncertainty and inconsistency in their recent implementation means that they are drawing industry and supervisory scrutiny and require industry harmonisation.

While many of last year's topics remain relevant for this year, there is now a shift in focus as we begin to look beyond Brexit to other issues, such as climate change, which start to take centre stage. Scroll through or select a topic below

Key stage in the regulatory change or implementation cycle *Uncertainty and inconsistency* *Emerging trend*

1 Future Regulatory Framework

Key dates

- Early 2020: FCA to publish a Discussion Paper on reviewing the Principles for Businesses and to consult on a duty of care
- 31 January 2020: UK to leave the EU (assuming no further extension)
- 1 February 2020 – 31 December 2020: Potential transitional period (if Brexit deal is agreed)

Brexit process

Following the UK election result, the UK likely will leave the EU with a Withdrawal Agreement in place on 31 January 2020. This would mean that the legal status quo is preserved during a transitional period, which will run until the end of the year (according to the amended Withdrawal Agreement Bill, there will be no extension). Therefore, although there will be no major changes at the end of January, firms will only have until the end of 2020 to prepare for whatever Brexit-related changes will take place, which in turn will depend on what is agreed politically in terms of the future UK-EU relationship.

Therefore, in reality the Withdrawal Agreement will only serve to push the potential of no-deal (with the loss of passporting) back until the end of this year. The question for 2020 will be whether the government can agree any sort of meaningful trade deal for the financial services industry in the time available.

Most of the UK onshoring legislation has been made into law, and is ready to come into force if there is no deal. Therefore firms can (if they wish) prepare for transition to the onshored regime as it currently stands. However, this position could change to reflect the terms of any agreement relating to the future UK-EU relationship (depending on what is agreed), and so firms will experience further Brexit uncertainty this year as they wait for the outcome of negotiations. The Financial Services Bill announced in the Queen's Speech does not offer any indication that there are ambitions for close alignment with the EU in the future. Although the election result has set a clearer path, the ultimate outcome for the financial services industry remains unclear and firms still have many unanswered questions.

The future of regulation

With Brexit potentially nearing a conclusion, thoughts will turn not only to the future UK-EU relationship, but also to the UK's position globally. During 2019, several workstreams emerged to examine the potential future direction of UK financial services regulation. First, the Treasury Committee opened an inquiry into the future of the UK's financial services sector. This inquiry was set up to examine what the government's financial services priorities should be when it negotiates the UK's future trading relationship with the EU and third countries, how the UK's financial services sector can take advantage of the UK's new trading environment, and whether the UK should maintain the current regulatory barriers that apply to third countries. The inquiry was closed due to the dissolution of Parliament before the election, but it is expected that this work will be revived in 2020.

Second, HM Treasury is carrying out a review of the future regulatory framework for financial services. The first phase of the review was launched in July 2019, with a call for evidence on regulatory coordination. Further phases are due to be announced once the arrangements for the UK's future relationship with the EU have become clearer,

1 Future Regulatory Framework *continued*

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with the intention of looking more deeply into how the UK should adapt to its new status outside of the EU.

With an eye on the future, the UK regulators have already started cementing relationships with regulators in other countries. They entered into various new Memoranda of Understanding in 2019, and set up relationships with US, Asian, and even some European regulators.

Since the referendum decision, the EU legislators have been working to tweak various existing EU regulatory regimes. This includes narrowing several third-country regimes, which will affect not only the UK post-Brexit, but also existing third-country jurisdictions. One example of this is the amendments to EMIR, known as EMIR 2.2, which were made into law in December 2019. These changes will empower the European Commission to determine that some third-country CCPs are of such systemic importance that they can provide services in the EU only if they are located in the EU. This amendment has proved controversial within the EU, as well as outside the EU, as the European Commission and ESMA have disagreed about the proposed criteria for categorising third-country CCPs.

The EU has also been preparing changes to the role of the European Supervisory Authorities (ESAs), with a view to giving them greater powers, thereby creating more harmonisation across Europe. At present, the ESAs have limited supervisory powers, but will take on a greater role in future. For example, ESMA will become the supervisor for third-country benchmark administrators and for data reporting service providers, rather than leaving this task to national regulators.

At a global level, divergent views on regulation have led to concerns about market fragmentation. Different approaches to post-crisis reforms demonstrated the difficulties that can arise when jurisdictions use divergent tactics to address the same problem. Both the FSB and IOSCO published reports on market fragmentation in 2019, with the FSB examining the trading and clearing of over-the-counter derivatives across borders, banks' cross-border management of capital and liquidity, and the sharing of data and other information internationally as particular problem areas. The reports aim to consider where reducing market fragmentation might have a positive impact on financial stability or improve market efficiency. With Brexit likely to lead to more market fragmentation if UK regulation deviates from the EU position, this work will take on heightened significance.

2 Scheduled European Reviews

Key dates

- March – July 2020: Various reports reviewing elements of MiFID II due for publication
- By April 2020: European Commission to submit a report on its review of the EU Benchmarks Regulation to the Parliament and Council
- Spring 2020: ESMA to submit its final report on the MAR review to the European Commission

MiFID II

A large number of MiFID provisions are due for scheduled review, with the European Commission expected to prepare and submit reports by either 3 March 2020 or 3 July 2020. These reports will be based on input from ESMA, and ESMA has already run calls for evidence on some topics. However, at least some of the reports are expected to be delayed, due to the volume of work required and other events impacting workload, such as Brexit.

The reviews cover a broad spectrum of MiFID topics. For example, ESMA has already gathered feedback on disclosures relating to inducements and costs and charges on the investor protection side, as well as on market data prices and the consolidated tape on the markets side. ESMA is also working on a comprehensive review report for the transparency regime, and has indicated that it intends to consult on this in early 2020. It is not clear at this stage which areas will result in proposed legislative change, and when such changes might be expected to come about. In a speech in November 2019, ESMA highlighted some areas of the review undertaken to date. ESMA indicated that it might explore whether disclosure requirements for non-retail clients should be reviewed, and that it is considering what the appropriate next steps should be in terms of prices for market data, and establishing a consolidated tape.

Areas such as the scope of the share trading obligation, the double volume cap mechanism, the commodity derivatives regime, and issues with data and reporting requirements also seem ripe for review. It will be important for market participants to monitor these reviews during 2020, and feed into any consultations that concern them.

At UK supervisory level, we expect the FCA to continue to focus on a number of areas in 2020, including research unbundling and best execution. In particular, the FCA is due to conduct further work looking into research pricing models and valuation, following its September 2019 feedback on research unbundling.

MAR

ESMA consulted on the MAR review in autumn 2019. ESMA is currently considering the feedback received and is due to submit a final report to the European Commission in spring 2020. This report could lead to proposals for changes to the Level 1 text. Although the focus of the review is meant to be solely on the Level 1, ESMA has indicated that it is very much in listening mode, and may well consider other issues and follow up with new guidance where appropriate.

Key issues raised by the consultation include whether or not MAR should be extended to cover spot FX, and whether the market soundings regime is a safe harbour or mandatory regime. The consultation does not address important areas, such as the extraterritoriality of the regime or the difficulties with the investment recommendations regime. Respondents to the consultation have highlighted these areas, so it will be interesting to see whether ESMA and the Commission are willing to examine them.

2 Scheduled European Reviews *continued*

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Aside from the planned review, the EU legislators finalised some changes to MAR as part of their work in relation to SME growth markets. The amendments to MAR will take effect from 1 January 2021. As well as making some changes specific to SME growth markets, the amendments will modify the market soundings regime to carve out communications relating to bond issuances addressed solely to qualified investors, and will clarify the timing for an issuer to make public the information contained in a PDMR notification (currently MAR conflates the period for the PDMR to notify the issuer, and for the issuer to make the information public).

Domestically, 2019 has seen a focus on so-called "secret polling" activities, with exchanges between the Treasury Committee and the FCA about the risks to financial markets of using private polling to give a trading advantage in advance of election results. Although this activity does not fit squarely within MAR, it may do so under certain circumstances (*i.e.*, when the information meets the definition of inside information). However, the FCA has stressed that MAR alone is not sufficient to prevent this activity, and that the government must consider whether new legislation is required.

EU Benchmarks Regulation

The European Commission is also carrying out a planned review of the EU Benchmarks Regulation (BMR). The Commission was mandated to report on the regime by 1 January 2020, but since the Commission's consultation on the review only closed at the end of 2019, the report is now expected in spring 2020.

The consultation focuses primarily on topics that the BMR itself mandates to be reviewed, such as the regime for critical benchmarks and the regime applicable to EU benchmark administrators. However, the consultation also addresses some additional topics that market participants have been grappling with, such as the rules for third-country benchmarks. This is a key opportunity for market participants to provide feedback on certain issues, such as the very broad scope of application of the BMR and challenges in complying with the prescriptive requirements of the BMR in practice.

Although amendments to the BMR have extended the transitional period for critical and third-country benchmarks until the end of 2021, it remains important that the Commission considers how the regime could be improved, given that many third-country benchmark providers are struggling with some of the practical requirements the regime has laid down for them. For example, difficulties are due to the lack of clarity on what BMR equivalent compliance may need to look like in the context of their existing IOSCO frameworks, or due to the level of oversight of their business required by an EU firm if they opt to pursue the recognition or endorsement routes. This lack of certainty contributes to the difficulty third-country providers face to accept the legal and regulatory risks associated with accessing the EU, which in turn increases the risk of disrupting many EU financial contracts.

3 LIBOR Transition

Key dates

- First half of 2020: ISDA expected to facilitate implementation of permanent cessation fallbacks
- End 2021: FCA will cease requiring banks to contribute to LIBOR

Transition away from LIBOR

Work is progressing on the transition away from LIBOR, but not as fast as the regulators would like. On 21 November 2019, the FCA published a speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, on next steps in the transition.

The speech outlined the progress made to date and key next steps. Achieving progress in relation to sterling swaps and loan markets is a primary goal for 2020, as progress in these markets has been slow so far. In sterling interest rate swap markets, the FCA will encourage market makers to make SONIA the market convention from Q1 2020. LIBOR is still common in corporate lending, including in syndicated loans. The Working Group on Risk-Free Reference Rates has set a target of Q3 2020 to stop new lending using LIBOR.

Mr. Schooling Latter also emphasised yet again that a time may come when LIBOR is no longer representative, but before contractual cessation triggers kick-in. He stressed that the inclusion of pre-cessation triggers in contractual documentation is the best way to prepare for the risk of LIBOR becoming unrepresentative, for products that have not moved away from LIBOR.

The FSB recently wrote to ISDA to suggest that the inclusion of pre-cessation language should be mandatory in the standard documentation, without any optionality. However, the industry is divided on whether and how to include pre-cessation triggers in the ISDA protocols, which is delaying finalisation of the documentation. The FSB has also been working to encourage firms to accelerate their move away from LIBOR. The FSB plans to conduct a survey of financial institutions' exposures to LIBOR and the supervisory measures in place to help address problems with the transition, and will share its findings with G20 finance ministers and central bank governors in July 2020.

Meanwhile, firms continue to grapple with the practicalities of transitioning away from LIBOR. For example, the PRA has been working on the potential interactions between the prudential framework and benchmark rate reform, after the Working Group on Risk-Free Reference Rates highlighted some of the issues that the current regulatory capital framework poses in terms of benchmark transition.

3 LIBOR Transition *continued*

Key dates

- First half of 2020: ISDA expected to facilitate implementation of permanent cessation fallbacks
- End 2021: FCA will cease requiring banks to contribute to LIBOR

LIBOR and conduct risk

Although the transition away from LIBOR clearly poses operational and financial risks, firms may not have considered the importance of conduct risk. In November 2019, the FCA published new guidance setting out its expectations of firms regarding conduct risk arising from the transition away from LIBOR. The FCA's key concern is that firms have a clear plan in place for their transition, and that they treat customers fairly.

The guidance covers a range of topics, from governance to communicating with customers. Key takeaways for firms include:

- LIBOR transition will affect overall business strategy, and must not be viewed as a narrow legal and compliance risk
- Firms should have a designated Senior Manager with responsibility for overseeing LIBOR transition (and this should be documented in the individual's Statement of Responsibilities)
- LIBOR transition should not be used as an excuse to move customers to rates that are expected to be higher than LIBOR, or to otherwise introduce inferior terms
- Firms will need to consider whether any unilateral variation terms (and other contractual terms being introduced to address the transition away from LIBOR) are fair for the purposes of the Consumer Rights Act 2015
- Firms must ensure that communications are fair, clear, and not misleading, and that information is presented in good time to allow customers to make informed decisions

Although the end of 2021 may still feel like a long way off, it is important for firms to start making headway during 2020. Considering the lead times for amending customer documentation and communicating with customers to provide sufficient notice, the end of LIBOR (at least as we know it) will come round all too quickly.

4 New Prudential Regime for Investment Firms

Key dates

- Q1 2020: Expected FCA Consultation Paper on UK implementation
- 26 June 2021: New regime comes into effect

The new regime

Since 2015, the EU has been working towards reforming the prudential regime for investment firms, and making it more proportionate to the risks posed by investment firms. This work is captured in the Investment Firms Regulation and Investment Firms Directive, which were published in the Official Journal in December 2019. The FCA is expected to consult on UK implementation in early 2020. The rules will apply from 26 June 2021, so will come into force post-Brexit. However, the UK government and the FCA have signalled an intention to replicate this legislation in the UK.

At present, many smaller investment firms typically are classified for prudential purposes as either BIPRU firms or exempt CAD firms. In both cases, relatively light capital and remuneration standards apply. Larger firms carrying out more extensive activities are subject to capital and remuneration requirements under the CRD IV framework, and must comply with much more onerous and complex provisions. Although the reforms have been billed as creating a simpler and more proportionate regime, many firms will see an uplift in their requirements.

The new rules will offer four streamlined classifications (down from the current 10). The top two classifications (referred to as "Class 1" and "Class 1 minus") relate to the largest and most systemically important investment firms, and are applicable only if a firm deals on own account or carries out underwriting/placing on a firm commitment basis. Class 1 firms will be required to convert into credit institutions and will be subject to the full CRD IV requirements. Class 1 minus firms will remain authorised under MiFID, but will be subject to the prudential requirements under CRD IV.

Class 2 operates as the "default" classification, and it is anticipated that most MiFID investment firms will fall within this category, as Class 3 is quite restrictive. To qualify as a Class 3 firm, a firm cannot hold client money or safeguard/administer assets. In addition, some K-Factors (which measure the risk posed by a firm, relative to the nature and volume of its activities) must be zero (including, for example, those relating to net position risk, clearing margin given, trading counterparty default, and daily trading flow). For many current BIPRU or exempt CAD firms, the above requirements may well be met. However, certain other thresholds will be more problematic. Specifically, to qualify as a Class 3 firm, the firm must, in summary: (a) have less than €1.2 billion in assets under management on an individual and group basis; (b) handle client orders of less than €100 million/day for cash trades, or €1 billion/day for derivatives on an individual or group basis; (c) have total annual gross revenue of under €30 million on an individual and group basis; and (d) have an on and off balance sheet total of below €100 million.

4 New Prudential Regime for Investment Firms *continued*

Key dates

- Q1 2020: Expected FCA Consultation Paper on UK implementation
- 26 June 2021: New regime comes into effect

Navigating classification

The dividing barrier between Class 2 and 3 is granular and technical, and firms should ensure they properly engage with the criteria. Firms falling into Class 2 face a significantly heightened compliance burden compared with Class 3 firms. In summary:

- Class 2 firms will be subject to a permanent minimum capital requirement of €150,000 (provided they do not deal on own account or underwrite) with complex variable capital requirements that take into account the K-Factors (see above). For many Class 2 firms, this will mean holding significant capital in excess of their permanent minimum requirement. Class 3 firms will be subject to a permanent minimum capital requirement of €75,000 and a variable capital requirement that is the higher of their minimum requirement and one-quarter of the previous year's fixed overheads.

- Class 2 firms will be subject to a number of other prudential requirements that may not apply to Class 3 firms. These include liquidity rules, large exposures, ICAAP, Pillar 3 public disclosures, and other regulatory reporting requirements.

- Class 3 firms will remain subject to the non-prescriptive MiFID II remuneration and governance regime. In contrast, Class 2 firms will be upgraded to more onerous remuneration requirements that resemble the requirements in some current regimes (*e.g.*, CRD IV, AIFMD, and UCITS). For high earners/material risk takers, these requirements include pay deferrals, a requirement for some pay to take the form of non-cash instruments, and malus and clawback mechanisms. However, Class 2 firms will not need to apply the bonus cap. Class 2 firms will also be required to put in place a gender-balanced remuneration committee and fulfil onerous public disclosure requirements.

5 Financial Crime / AML

Key dates

- 10 January 2020: Transposition deadline for MLD5

STORs and SARs

The interaction of the suspicious transaction and order reports (STORs) regime under MAR and the suspicious activity reports (SARs) regime under the Proceeds of Crime Act 2002 has recently come under scrutiny. The FCA published a letter to UK Finance, clarifying when it may be necessary for firms to submit a STOR or a SAR, or both. The FCA emphasised that, although the regimes cover different activities, there is some overlap, and firms may need to submit a STOR and a SAR in relation to a single order or transaction. Firms are reminded that submitting a STOR to the FCA does not discharge a firm's obligation to submit a SAR to the National Crime Agency, or vice-versa. Therefore, firms need to make sure that they understand what is required in different situations.

Separately, work to improve and reform the SARs regime continues. The Law Commission published its final recommendations in June 2019, and the government must now consider how to take these recommendations forward. Key recommendations include introducing new statutory guidance on a number of key legislative concepts underpinning the reporting regime, and using technology to devise an online interactive form so that SARs are made in a prescribed form.

MLD5 implementation

EU Member States are due to transpose MLD5 by 10 January 2020. Changes include extending AML requirements to cryptoassets, creating new national bank account registers so that bank account information can be obtained easily by enforcement agencies, mandating enhanced due diligence for activities involving high-risk third countries, and increasing transparency around the beneficial ownership of corporates and trusts. In relation to cryptoassets, MLD5 provides that AML requirements should apply to virtual currency exchange platforms and custodian wallet providers. HM Treasury consulted on whether it should gold-plate this requirement to cover other activities involving cryptoassets, such as crypto-to-crypto exchanges and initial coin offerings. HM Treasury confirmed at the end of 2019 that it would extend AML requirements to firms offering cryptoasset exchange services, firms involved in the issuance of new cryptoassets, and cryptoasset ATMs. However, it will not extend these requirements to non-custodian wallet providers. The UK will adopt a definition of cryptoassets that includes exchange, security and utility tokens for these purposes, thereby capturing all three types of cryptoassets. For further on the development of cryptoasset regulation, please see Section 10 below.

There has been a sharp focus on AML oversight and supervision recently, given some high-profile scandals. The ESAs have published new guidance on effective cooperation and information exchange between national regulators. The guidance is meant to ensure that, in future, supervisors from different Member States have a formal cooperation framework that ensures adequate and effective AML supervision of firms that operate on a cross-border basis. Further, there are ongoing discussions among the European legislators as to whether there should be a central AML authority to supervise compliance with AML obligations across the EU.

6 Green Finance and Climate Change Risk Management

Key dates

- Q1 2020: FCA to consult on new issuer disclosure rules
- Q2 2020: FCA to start considering future priorities on climate change and green finance as part of its business planning

Direction of travel

Although sustainable finance has been on the regulatory radar for a few years, there were increased efforts in 2019 to push forward a green finance strategy and address how the financial sector can play a key role in helping to tackle climate change. We have seen numerous policy proposals emerge and develop, and 2020 will be a key year in which firms will be expected to start really taking action in relation to environmental issues.

EU initiatives

The key EU measures in this area centre around the European Commission's Sustainable Finance Action Plan. The Plan was first published in March 2018, with the aim of helping to position the EU financial sector at the forefront of establishing a green economy. This was followed in May 2018 by a series of legislative proposals, most of which have been adopted recently or are expected to be adopted shortly.

Key legislative measures include:

- Creating a unified EU classification system (a taxonomy) for determining whether an economic activity or investment qualifies as environmentally sustainable. This measure will establish consistent criteria for labelling a product as "green". These criteria are to be applied by financial market participants creating and distributing green products, and by Member States setting out national rules on labelling investment products.
- The so-called "Disclosure Regulation", which aims to improve disclosure on how institutional investors and asset managers integrate ESG factors into their decision-making processes, how their investments correlate to their ESG targets, and how they comply with these targets.
- Legislation amending the EU Benchmarks Regulation to introduce a new category of low-carbon benchmarks. This new market standard will help investors to compare the low-carbon attributes of investments and portfolios.
- Amendment of the MiFID II Delegated Acts and the Insurance Distribution Directive to help investment firms and insurance distributors to incorporate ESG factors into the advice and product distribution process.

The taxonomy is the key piece of work underpinning this initiative, as without a common standard for what is classed as "green", the labelling of products will not be consistent, readily understood, or reliable. However, because of its importance, the taxonomy has proved to be controversial in places, and political agreement was only reached in December 2019.

The new European Commission President has made clear that sustainable finance will be a key priority for the new Commission. As well as completing the outstanding elements of the Sustainable Finance Action Plan, the Commission intends to start preparing another set of green finance initiatives, scheduled for publication in autumn 2020.

6 Green Finance and Climate Change Risk Management

continued

Key dates

- Q1 2020: FCA to consult on new issuer disclosure rules
- Q2 2020: FCA to start considering future priorities on climate change and green finance as part of its business planning

UK initiatives

In the UK, the government published its Green Finance Strategy in July 2019. The Strategy sets out how the UK government aims to accelerate the growth of green finance, and enable the UK to seize the commercial potential arising from the transition to a sustainable economy. The Strategy materials emphasise the key role that the financial services sector will play in tackling climate change. To this end, the government plans to clarify the need for financial regulators to consider climate change when advancing their objectives and discharging their functions. The initial Strategy paper was fairly high level, so we expect more granular and detailed policy proposals to emerge in the year ahead.

The regulators have already started to publish their own measures relating to climate change and green finance. In April 2019, the PRA published a Supervisory Statement (SS3/19) on banks' and insurers' approaches to managing the financial risks from climate change. The PRA uses the Supervisory Statement to explain how financial risks from climate change arise, how these risks present unique challenges for firms, and how the PRA expects firms to take a strategic approach to tackling them. The FCA published a Feedback Statement (FS19/6) in October 2019, as a follow-up to its October 2018 Discussion Paper on climate change and green finance. In the Feedback Statement, the FCA sets out its planned next steps in this area. These include:

- Consulting in early 2020 on proposed new disclosure rules for issuers, aligned with the TCFD recommendations, and clarifying existing disclosure obligations relating to climate change risks
- Carrying out further policy analysis on greenwashing, and clarifying the FCA's expectations with regard to greenwashing
- Continuing with existing work on stewardship, the facilitation of investment in patient capital, and rule changes requiring Independent Governance Committees to oversee and report on firms' ESG and stewardship policies
- Continuing with various initiatives with the government, other regulators, and industry on these issues, including the Climate Financial Risk Forum, the Fair and Effective Markets Review working group, the government-led cross-regulator taskforce on disclosures and the European Commission's Sustainable Finance Action Plan

7 Governance, Risk Management, and Accountability

Key dates

- March 2020: The Directory to go live
- 7 December 2020: SMCR to apply to benchmark administrators
- 9 December 2020: FCA solo-regulated firms to have completed initial certification exercise for all employees and trained all staff on the Conduct Rules

SMCR implementation

The Senior Managers and Certification Regime (SMCR) is now in force for almost all authorised financial services firms, following the extension to FCA solo-regulated firms on 9 December 2019. HM Treasury has delayed the application date of the SMCR for benchmark administrators who carry on no other regulated activities to 7 December 2020, and the FCA is currently consulting on how the regime will apply to such firms.

However, SMCR should not be moving off firms' radars now that implementation dates have passed. For firms already within the regime, whether newly subject to the rules or not, now is a good time to be conducting or planning a post-implementation review to ensure that the firm is fully compliant. The regulators will be continuing to focus on firms' implementation of the regime during 2020, and we also expect some enforcement action to come to fruition. According to a Freedom of Information Act response in June 2019, the FCA had 15 open enforcement investigations into Senior Managers as of that date.

Enforcement cases against individuals often take a long time to reach their conclusion, but, almost four years after the original SMCR was rolled out to banks, it is expected that at least some cases will be reaching the end of the pipeline. Firms and individuals need to ensure that they review any enforcement cases carefully and consider what lessons can be learned.

Another important factor for firms to consider is ongoing compliance with the regime. SMCR documentation, such as Statements of Responsibilities, can swiftly become outdated, and should be updated and resubmitted whenever there is a material change. Firms also need to focus on ensuring that the right information feeds are passing to the correct people, so that fitness and propriety of Senior Managers and Certified Persons can be reassessed in a timely manner if an in-year event triggers such assessment.

Culture and conduct

Culture and conduct remain high on the FCA's agenda, with a continued focus on non-financial misconduct. Firms are still grappling with how to embed real, lasting change, and how to analyse and assess culture, which is an inherently nebulous concept.

To assist firms, Latham & Watkins has developed a culture framework, which seeks to help bridge the theory-practice divide by offering a practical toolkit, informed by recent insights, trends, and real-life case studies. Firms can draw on this framework to inform their own approach to culture change. While there may never be a "perfect" methodology for measuring culture, the framework outlines an array of measures and techniques that firms can usefully adopt in their quest to institute a meaningful and operationally workable culture change programme.

8 Operational Resilience

Key dates

- Early 2020: FCA to publish findings from cyber multi-firm review
- Second half of 2020: BoE, PRA, and FCA to provide feedback to consultations on operational resilience and outsourcing

Building operational resilience

Operational resilience has been gaining traction as a key regulatory topic in recent years. The UK regulators published a joint Discussion Paper on the subject in July 2018, and have now released a shared policy summary and co-ordinated Consultation Papers on new requirements to strengthen operational resilience in the financial services sector. Consequently, we can expect some concrete policy in this area during 2020.

Although the proposals only directly apply to PRA-authorised firms, FCA-authorised firms that fall within the Enhanced Regime under the SMCR, Recognised Investment Exchanges, payment services firms and e-money firms, other firms are encouraged to treat any resulting regulation as best practice guidance.

The proposals set requirements and expectations for firms and financial market infrastructures (FMIs) to:

- Identify their important business services by considering how disruption to the business services they provide can have a bearing beyond their own commercial interests, including, if relevant, harm to consumers, harm to market integrity, and threats to policyholder protection, safety and soundness, and financial stability. Once identified, the regulators would require boards and senior management to prioritise the operational resilience of these important business services over other business services. The regulators do not plan to introduce definitive lists or taxonomies of important business services, as the same business service may be important for one firm but not for another.

- Set a tolerance level for disruption for each important business service at the first point at which a disruption would pose an intolerable risk in various respects (for example, risk of harm to consumers, or to the firm's safety and soundness). Dual-regulated firms may have two impact tolerances for each business service — one focusing on safety and soundness, and the other focusing on consumer harm and market integrity.

- Carry out mapping exercises and scenario testing to ensure they can continue to deliver their important business services and are able to remain within their impact tolerances during severe but plausible scenarios.

Comments are requested on the proposals by 3 April 2020, and it is expected that the final policy documents will be published later in 2020. The PRA states in its consultation that the proposed implementation date for the proposals is the second half of 2021. Although there will be a substantial lead-in time for the new requirements, given the increasing importance of operational resilience, firms should consider what steps they could be taking now in advance of having to comply with prescribed regulatory requirements.

8 Operational Resilience *continued*

Key dates

- Early 2020: FCA to publish findings from cyber multi-firm review
- Second half of 2020: BoE, PRA, and FCA to provide feedback to consultations on operational resilience and outsourcing

This is not just a UK concern; the European Commission published a consultation on creating an enhanced framework for digital operational resilience of the EU financial sector in December 2019.

Outsourcing

Outsourcing is also attracting a great deal of regulatory scrutiny, due to firms' increasing reliance on third-party providers, the increasingly complex nature of outsourcing arrangements, and groups restructuring in light of Brexit. The new EBA Guidelines on outsourcing came into effect at the end of September 2019, representing a significant uplift in expectations for most firms. There have also been several outsourcing-related enforcement cases recently, highlighting that firms are not always paying sufficient attention to their outsourcing arrangements, particularly in terms of carrying out due diligence on service providers and having robust contractual documentation in place.

Linked to its paper on operational resilience, the PRA published a Consultation Paper on outsourcing and third-party risk management. The PRA is consulting on a new Supervisory Statement to help modernise the regulatory framework in this area. The key objectives of the Supervisory Statement are to complement the policy proposals on operational resilience, implement key EU guidance (including the EBA Guidelines) by clarifying precise expectations, and facilitate greater resilience and adoption of the cloud and other new technologies.

The consultation closes to responses on 3 April 2020 and the PRA intends to publish its final policy in the second half of 2020, in line with the final policy on operational resilience. Implementation of the majority of the proposals will follow shortly afterwards. However, the proposals are unlikely to change significantly during the consultation process, so PRA-regulated firms should review the draft Supervisory Statement and consider what they could be doing now to improve their approach to outsourcing.

Firms face a challenge in pulling together the multiple strands of regulatory reform in relation to operational resilience and outsourcing, as well as finding the efficiencies in implementation across their international business lines.

9 Settlement Discipline

Key dates

- 14 September 2020: Settlement discipline measures under the CSDR take effect

New settlement discipline requirements

The settlement discipline provisions under the Central Securities Depositories Regulation (CSDR) are due to take effect later this year (although timetabled to apply from September, their application may be delayed until November 2020), but they have received relatively little attention to date. These rules aim to improve settlement efficiency by introducing measures such as cash penalties for settlement fails and a mandatory buy-in regime. They will affect most parties in the settlement chain, from trading venues and CSDs, to banks and asset managers. Firms that have not already prepared themselves for implementation will need to get up to speed with the requirements quickly this year.

The buy-in regime will create a compulsory obligation for purchasing parties to execute buy-ins against sellers who fail to settle their trades within a required period. This obligation will attach to the end purchaser, rather than any of the intermediaries in the settlement chain. It will require purchasers (or CCPs, if the trade is cleared by a CCP) to initiate the buy-in process after a trade has failed for four business days (in the case of liquid equities) or seven business days (in the case of all other securities). The buy-in itself must then be completed within a further four or seven business days. There is one opportunity to defer this period. Ultimately, if the buy-in cannot be completed, the trade must be cancelled, and there is provision for cash compensation to be paid.

The regime will have a broad scope, since it will apply to trades that are intended to settle on any EEA regulated CSD. It will apply to trades in transferable securities, money market instruments, units in collective investment undertakings, and emissions allowances that are admitted to trading or traded on a trading venue, or cleared by a CCP.

Therefore, the regime will have wide extraterritorial effect, as even third-country purchasers will need to comply with the buy-in requirements. Even though such entities are not within scope of the CSDR, the Regulatory Technical Standards require that all parties in the settlement chain must have contractual arrangements in place that not only require the relevant counterparties to comply with the regulatory obligations of the buy-in regime, but that also ensure that the CSDR is enforceable in all relevant jurisdictions. As we have seen in recent years with regimes such as MiFID II and MAR, the workability of such "indirect" extraterritorial application proves to be very difficult in practice.

Industry groups have been lobbying against the introduction of a mandatory buy-in regime in certain markets, arguing that this is a crude method and that other measures could help improve settlement efficiency. There are particular concerns about the potential impact of the regime on market liquidity and on pricing.

10 FinTech: Cryptoassets

Key dates

- Early 2020: FCA to publish a Policy Statement on prohibiting the sale to retail clients of derivatives and exchange traded notes referencing certain types of cryptoassets
- 12 March 2020: End of feedback period for European Consultation on the regulatory framework for cryptoassets
- 2020: HM Treasury expected to consult on whether the regulatory perimeter should be extended to cryptoassets with comparable features to specified investments

Regulatory treatment

Regulators continue to deliberate over how cryptoassets should be treated from a regulatory perspective. In the UK, the FCA finalised its guidance on cryptoassets in July 2019, and published a consultation on restricting the sale to retail clients of investment products that reference cryptoassets. The Policy Statement to this consultation is expected early this year. Meanwhile, HMRC issued some further guidance clarifying the application of corporate tax rules to cryptoassets. HM Treasury was due to consult on potential changes to the regulatory perimeter relating to cryptoassets during 2019, but this consultation is now expected to take place in 2020. Cryptoassets are also being brought within scope of AML regulation (see Section 5, above).

Separately, in November 2019, the UK jurisdiction taskforce of the LawTech Delivery Panel published a paper concluding that cryptoassets, including virtual currencies, can be treated in principle as property, and that smart contracts are capable of satisfying the requirements of contracts in English law and are thus enforceable by the courts. This is an important boost to legal certainty in the UK, and may help to make the UK a more attractive jurisdiction for the FinTech sector.

Although slower off the mark, the EU is now gearing up its efforts in relation to cryptoassets. The European Commission published a consultation in December 2019, to seek views on whether the existing regulatory framework is suitable for cryptoassets, including stablecoins. The Commission is considering whether the regulatory perimeter should be extended to capture types of cryptoassets that are not caught by existing rules. It also raises the possibility of introducing new, stringent measures in relation to cryptoassets, such as an obligation for assets or funds to be held in custody with credit institutions in the EU, or for issuers or sponsors of cryptoassets marketed to EU investors to be established or have a physical presence in the EU.

At an international level, the Basel Committee on Banking Supervision is gathering thoughts on how to approach the prudential treatment of banks' exposures to cryptoassets. The Committee's initial view is that banking entities that acquire cryptoassets or provide related services should apply a conservative prudential treatment to such exposures, especially for high-risk cryptoassets. The Committee also believes that stablecoins warrant further assessment and elaboration before it specifies a prudential treatment for them, since their stability has not yet been fully tested. The Committee may decide to consult on formal proposals later in the year.

Stablecoins and payments

The emergence and proliferation of stablecoins is an important global trend. Given their inherently data-centric and financial nature, stablecoin projects face various legal and regulatory hurdles, some of which are unique from traditional cryptocurrencies. In particular, the more recent development of "global stablecoins", which have the

10 FinTech: Cryptoassets *continued*

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potential to disrupt traditional payments systems and other financial services, has provoked increased governmental and regulatory scrutiny of how best to regulate these projects.

A stablecoin is a cryptoasset designed to have low volatility and to consistently reflect the value of a reference asset, or assets, with identifiable value (such as currencies, commodities, or securities). By seeking to achieve price stability, stablecoins aim to overcome the significant volatility that is a key limitation preventing the adoption of cryptoassets as a means of exchange or a store of value (rather than a means of speculation). Governments are grappling with the implications of stablecoin use, including potential consumer fraud or loss, financial crime and tax evasion, competition issues, and even reduced sovereign control of monetary policy and supply. As a result, regulators face questions regarding how to apply laws and regulatory regimes that did not contemplate the technology underpinning stablecoins or their uses. Legislators also need to consider whether to tweak existing legislative frameworks or implement new ones to accommodate such technology and uses.

In most major jurisdictions, whether a stablecoin is to be regulated as a security, a derivative, a stored value product, or an unregulated instrument turns on the precise structure. Generally speaking, currency-backed and asset-backed stablecoins will be regulated as a security, derivative, or stored value product.

The FCA has provided specific regulatory guidance on the application of the UK regulatory framework to stablecoins. A number of jurisdictions (*e.g.*, Gibraltar, Malta, and Hong Kong) have gone further, developing technology-specific regulatory frameworks for digital assets that may apply to stablecoins. US regulators are still grappling with the treatment of stablecoins and how they may differ from other cryptoassets. At international level, the policy considerations raised in reports issued by both the G7 and the FSB are likely to provide the foundation for further work on stablecoins by governments and regulators. The FSB has also indicated that it plans to issue a public consultation on addressing regulatory issues of stablecoins in April 2020. The emergence of possible global stablecoins may be the impetus for governmental and international bodies to develop publicly issued and controlled stablecoins that digitally represent fiat currency. Two notable projects of this kind are underway, with the People's Bank of China announcing a project to issue the world's first national digital currency this year, and the European Central Bank announcing that it is analysing the technical aspects of a digital currency to assess the desirability and feasibility of a publicly issued cryptocurrency in the EU.

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