8 November 2023

Financial Regulation Monthly Breakfast Seminar

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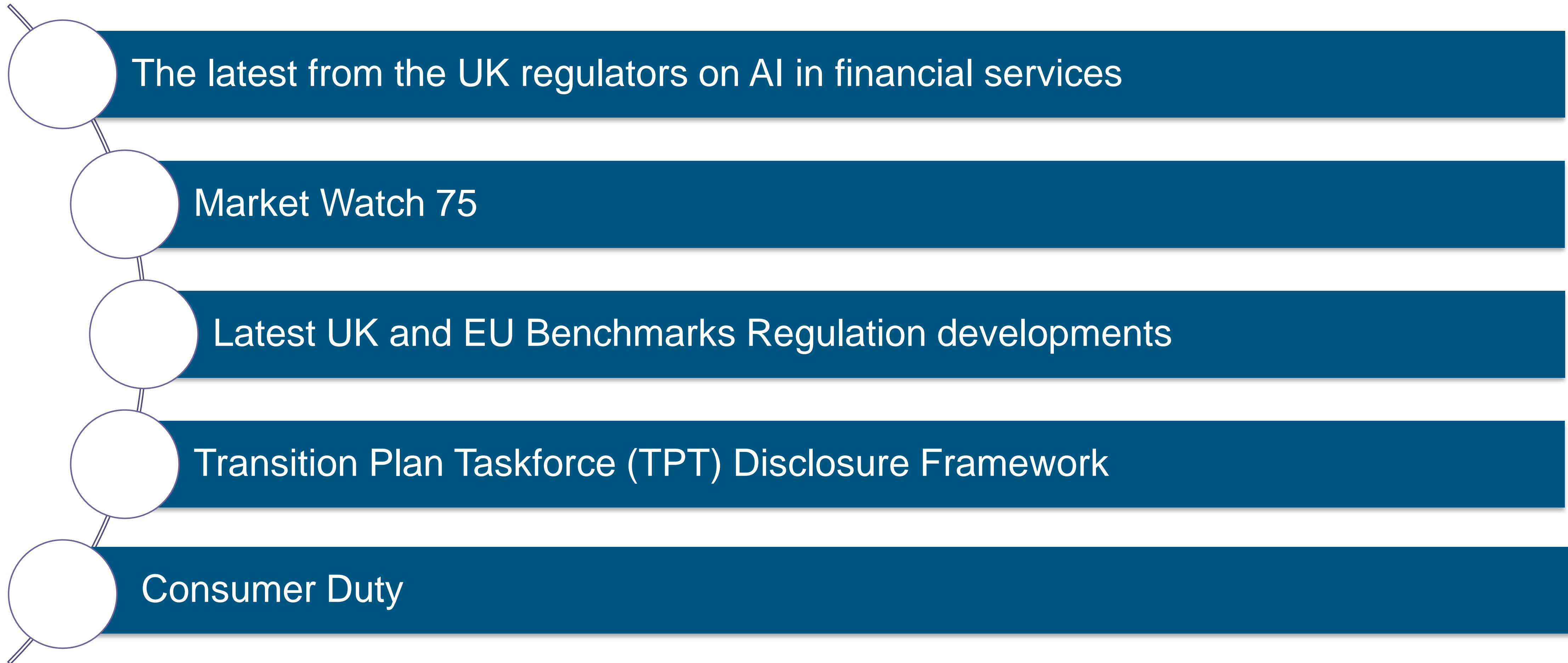

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The latest from the UK regulators on AI in financial services

Becky Critchley

Background

- General, long standing focus by UK financial services regulators on AI
- The Artificial Intelligence Public-Private Forum (AIPPF) was launched by the regulators in 2020 and has helped to develop suggestions for good practice by experts across the industry
- The FCA has made numerous speeches on AI recently, and suggests we are now at a "tipping point"
- The regulators published DP5/22 to explore the potential regulatory approach to AI in October 2022; this was followed up with FS2/23 published on 26 October 2023

UK government approach

- AI is a strategically important area for the UK government
- The government published a White Paper on its approach to regulating AI in March 2023, and hosted the AI Safety Summit on 1 and 2 November
- The government has announced its intention to take an "agile and iterative" approach to regulating AI – no legislation proposed at this stage

UK government approach (cont.)

- The government is proposing a framework centred on five ‘cross-cutting’ principles:
  1. Safety, security, and robustness
  2. Appropriate transparency and explainability
  3. Fairness
  4. Accountability and governance
  5. Contestability and redress
- Sectoral regulators responsible for appropriate implementation

Approach of the UK financial services regulators

- Any regulatory framework should be:
  - Principles-based,
  - Technology-agnostic, and
  - Outcomes-driven
- AI could bring significant benefits to the financial services sector, but there needs to be a balance between risk mitigation and promoting innovation
- Can AI can be managed through clarifications of the existing regulatory framework, or is a new approach needed?

Risks associated with the use of AI

- DP5/22 explored various potential risks associated with the use of AI in financial services
- The FCA also commissioned a report by the Alan Turing Institute, which analysed potential risks and benefits
- Some of the key risks raised relate to:
    - Consumer protection
    - Competition
    - Financial crime
    - Safety and soundness
    - Financial stability and market stability

Appliable existing regulation

The regulators used DP5/22 to outline areas of existing regulation applicable to firms' use of AI. These include:

- **Consumer Protection**: The FCA's Consumer Duty is relevant when considering consumer outcomes, fairness and potential discrimination. The FCA also has general powers under the Equality Act 2010 to protect individuals from discrimination
- **Competition**: The FCA's concurrent competition powers could be used to address competition-related concerns arising from the use of AI in financial services

Appliable existing regulation (cont.)

- **Data**: Provisions of the UK GDPR are applicable in the context of AI, supplemented by guidance on AI from the ICO. This is further supported by the provisions of the Money Laundering Regulations 2017 and the Payment Services Regulations 2017
- **Model risk management**: For banks, new PRA guidance on model risk management (MRM) frameworks is relevant. However, the current scope of MRM regulation is limited
- **Governance**: The FCA Handbook contains a number of high-level rules, principles, and guidance which would be applicable to firms' use of AI systems. Of particular relevance are rules relating to internal governance, systems and controls, internal audit, financial crime, risk control, outsourcing, and record-keeping

Appliable existing regulation (cont.)

- **SMCR**: The SMCR is relevant to a firm's use of AI, as Senior Managers may be held accountable for failures in areas for which they are responsible. Parliament has questioned whether it would be appropriate to introduce a dedicated SMF or Certification Function for AI under the SMCR
- **Operational resilience and outsourcing**: Many of the principles, expectations, and requirements for operational resilience may provide a useful basis for the management of certain risks posed by AI. The new framework for the supervision of critical third party arrangements introduced by FSMA 2023 will also be relevant

Feedback to DP5/22

- FS2/23 provides a summary of responses received to DP5/22. Key points made include:
  - Respondents do not consider that a regulatory definition of AI would be useful
  - A key area of focus for regulation and supervision should be consumer outcomes, particularly fairness and ethics
  - It could be helpful for regulators to design and maintain periodically updated guidance and examples of best practice, to keep pace with developments
  - More coordination and alignment between regulators, both domestic and international, would be helpful
  - More regulatory guidance in relation to the use of third-party models and data would be helpful
  - Existing firm governance structures, including under the SMCR, are sufficient to address AI risks

Next steps

- The UK government is due to issue a response to its White Paper this autumn – this will confirm the cross-cutting principles
- The regulators will use these and the feedback from DP5/22 to develop their work in relation to AI, including setting out how they propose to apply the cross-cutting principles within the financial services regulatory framework
- The Digital Regulation Cooperation Forum (DRCF) — which includes the FCA, ICO, Ofcom, and the Competition and Markets Authority — will launch the DRCF AI and Digital Hub next year to provide tailored advice to businesses on how to meet regulatory requirements for digital technology and AI

The bigger picture

- The US issued an Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence on 30 October 2023
- The G7 has published 11 Guiding Principles and a voluntary Code of Conduct for Advanced AI Systems
- 28 countries have signed the Bletchley Declaration agreeing to safe and responsible development of frontier AI
- The EU AI Act is making its way through the legislative process, and is expected to be finalised later this year
- The People's Republic of China has proposed and implemented a series of specific laws to regulate AI

Market Watch 75

Jonathan Ritson-Candler

FCA issues warnings on market soundings

- On 31 October 2023, FCA published Market Watch 75 reminding firms of the importance of having robust market soundings procedures
- Focus is on conduct of market soundings recipients (MSRs) in the period between consenting to being sounded and the sounding taking place
- Market soundings take place prior to the announcement of a possible transaction to gauge the potential interest of investors in that transaction (namely price and size)
- Market soundings can involve the disclosing market participant (DMP) communicating:
  - Confidential information; and/or
  - Inside information (and the market soundings process is a safe harbour to an unlawful disclosure offence on the basis it is within the DMP's normal exercise of their employment, profession or duties to communicate the MNPI)

FCA issues warnings on market soundings

- Market soundings are highly procedural, the majority of which is set out in UK MAR and onshored delegated legislation
- Includes the requirement on DMPs to determine if the sounding will involve MNPI as well as to confirm that an MSR consents to being sounded (and in turn being unable to trade until the transaction is announced or they are otherwise cleansed) and to remind the MSR of their responsibilities whilst in possession of MNPI
- MSRs are also under an ongoing obligation to determine for themselves whether the information communicated to them during a sounding is inside information

FCA issues warnings on market soundings

- In some cases, there is a period of time that arises between a DMP seeking an MSR’s consent to being sounded and the sounding taking place
- The FCA has observed there being a risk that during that period, MSRs may be able to identify the issuer and/or instruments that will be the subject of the forthcoming substantive sounding and trade during that period.
  - The FCA gives an example of when an issuer has previously held regular and similarly sized funding rounds executed by the same advisory firms, or where an MSR holds a very small number of investments in its portfolio, the MSR might be able to identify the issuer.

FCA issues warnings on market soundings

- The FCA has seen trading during that period and asked MSRs to explain the rationale underlying that activity, and its view is that the MSRs' explanations are not easily reconcilable with the circumstances of the trading
  - For example, an MSR selling a financial instrument immediately after a DMP has sought its consent to receive inside information, then buying the same quantity of the financial instrument back in the subsequent placing does not reconcile with "Rebalancing a portfolio"
  - Nor does this rationale reconcile easily with instructions to trade being phrased with urgency

FCA issues warnings on market soundings

- FCA therefore reminds MSRs of their obligation to assess if they have inside information and not to insider deal on the basis of MNPI
- FCA also reiterates that the market soundings safe harbour is only relevant to unlawful disclosure offences and not to UK MAR (civil) insider dealing offences or criminal insider dealing offences under the Criminal Justice Act 1993
- FCA suggests safeguards DMPs and MSRs can put in place to mitigate these risks:
  - MSRs can put in place “gatekeeper” arrangements where specific teams or staff in compliance are the nominated first point of contact for DMPs
  - MSRs should ensure staff receiving market soundings are properly trained
  - DMPs should minimise the period between obtaining consent from MSRs to be sounded and conducting the sounding

Latest UK and EU Benchmarks Regulation developments

Ella McGinn

EU BMR - proposals

- The EU Commission has published a legislative proposal to significantly reduce the benchmarks in scope of the EU Benchmarks Regulation (EU BMR) effective **1 January 2026**
- The EU BMR currently captures all benchmarks used within the EU by supervised entities that meet the relevant “benchmark” definition, regardless of their level of use or economic importance
- Revised EU BMR would apply only to critical benchmarks, significant benchmarks, EU Climate Transition Benchmarks and EU Paris-Aligned Benchmarks
- De-scoping of non-significant benchmarks

EU BMR – proposals (cont.)

- Benchmarks are significant if they are:
  - Referenced by financial instruments and financial contracts in the EU with a total value above €50 billion; or
  - Designated as significant because their discontinuation could have a significant adverse impact on financial stability, market integrity, or consumers
- Under the new proposed framework:
  - Administrators would notify their local regulator (or ESMA, for third-country administrators) when any benchmark they administer exceeds the €50 billion threshold
  - Administrator would then have 60 working days to seek authorisation, registration, endorsement, or recognition under the EU BMR

EU BMR – Impact of proposals for administrators

- ~90% of administrators would no longer be in scope of the EU BMR – but the Commission notes that it is established market practice to operate in accordance with the IOSCO Principles
- The position of regulated administrators who provide only **non-significant benchmarks** (including third-country administrators) is not directly addressed in the proposal – the implication is their regulated status would fall away when the proposals take effect on 1 January 2026
- Simplified authorisation procedure for administrators that fall out of scope as a result of the proposals if they then come back into scope within two years of the changes taking effect

EU BMR – Impact of proposals for third country administrators

- Third-country benchmarks currently qualify for EU use via equivalence, recognition, or endorsement – compliance with standards equivalent to the EU BMR
- Subject to transitional provisions on the application of the third-country regime (currently to end-2025)
- Commission is seeking to address concerns on availability of third-country benchmarks for use in the EU by limiting the number of third-country benchmarks subject to the regime
- Third-country administrators will be unable to administer EU Climate Transition Benchmarks or EU Paris-Aligned Benchmarks

EU BMR – Impact of proposals for benchmark users

- Ensure supervised users have continued access to a wide range of benchmarks, including third-country benchmarks
- Remove obligation on users to individually verify the regulatory status of indices they wish to use as benchmarks by consulting websites and public registers
- Users would only be required to check the ESMA register to verify that a benchmark is not subject to a public notice prohibiting its use

EU BMR – next steps

- Legislative proposals must be agreed by the European Parliament and Council
- The proposed 1 January 2026 application date coincides with the expiry of the transitional period for third-country benchmarks which has recently been extended to 31 December 2025

UK BMR – latest developments

- The UK has not yet reviewed the UK Benchmarks Regulation (UK BMR) as part of work to repeal and restate retained EU law
- On 7 November 2023 HM Treasury published a statement announcing a further extension to the third-country benchmarks transitional period under UK BMR to end-2030
- More time for the government to consider reforms needed to the third-country benchmarks regime
- The UK BMR is not scheduled for review in 2023 or 2024 – and it is not clear if the UK will adopt a similar approach to the EU

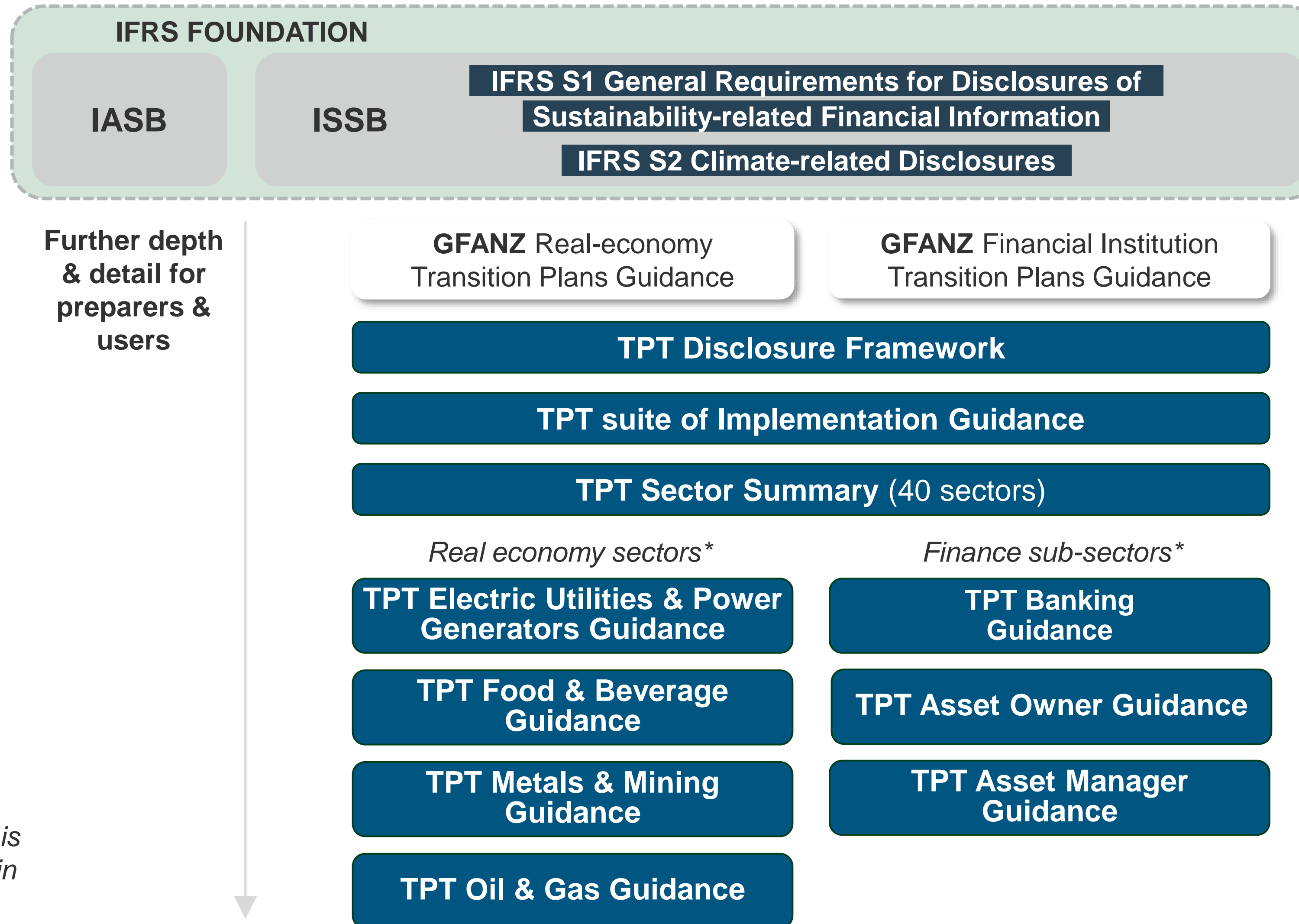
Transition Plan Taskforce (TPT) Disclosure Framework

Nicola Higgs

Transition Plan Taskforce (TPT) Disclosure Framework (1)

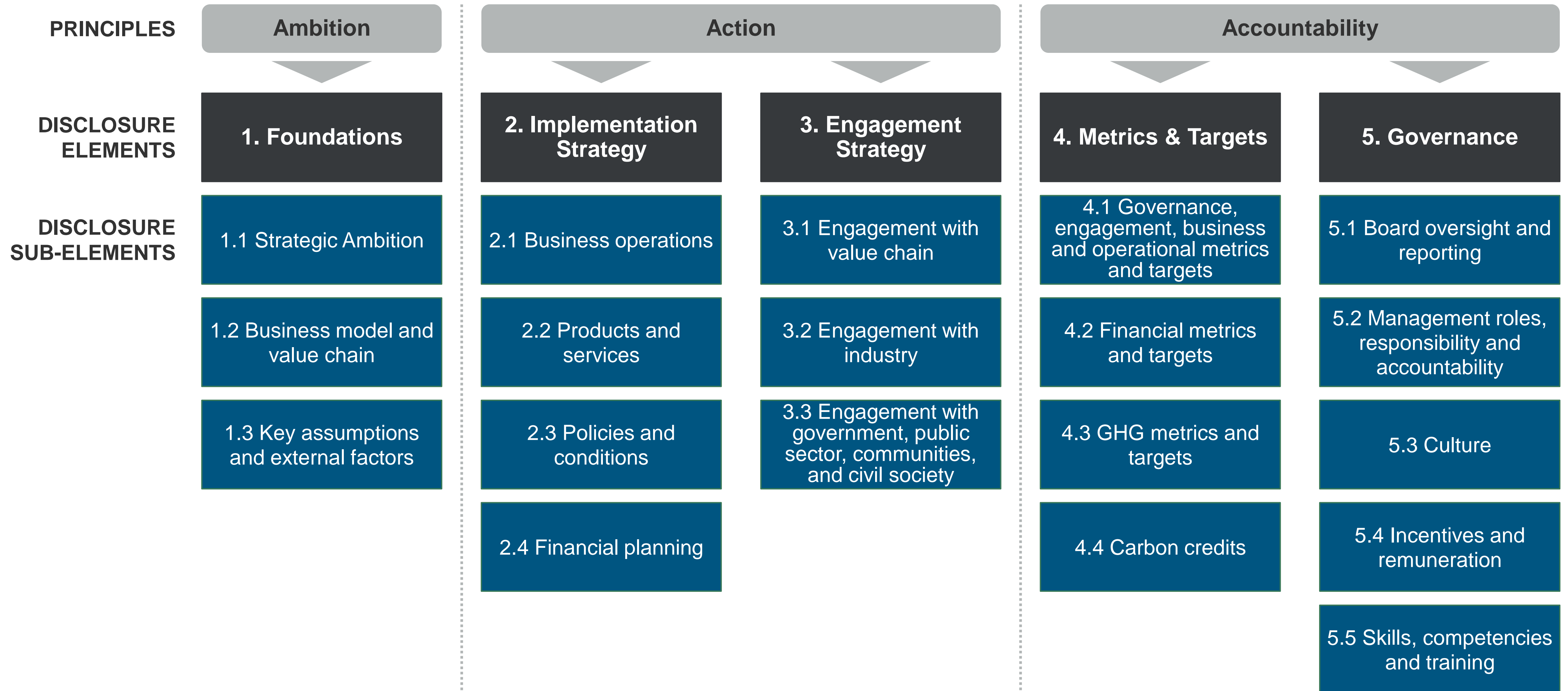
- 10 August 2023: FCA signalled its intention to consult on transition plan disclosures by listed companies in line with the TPT Disclosure Framework, alongside its consultation on implementing UK-endorsed ISSB Standards
- 9 October 2023: Publication of TPT Disclosure Framework. Anticipated to come into force for accounting periods from January 2025 (the first reporting would begin from 2026)
- Disclosure location: Integrate material information about the transition plan into general purpose financial reports in addition to producing a standalone transition plan
- Goal is to provide financial markets with better information on how companies plan to adapt their business models, their operations and their products and services in the context of their climate transition plans
- Consistent with GFANZ and ISSB

Transition Plan Taskforce (TPT) Disclosure Framework (2)



** This TPT Deep Dive guidance is to be published for consultation in November 2023*

Transition Plan Taskforce (TPT) Disclosure Framework (3)



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Consumer Duty
Rob Moulton

Introduction

- Speech by Nisha Arora, Director, Cross Cutting Policy and Strategy
- Financial Lives survey
  - 7.4 million people tried unsuccessfully to contact a financial institution last year
  - Examples included being able to buy but not cancel a policy online
  - Only 41% of adults have confidence in the financial sector

Improvements

- Simplifying language in letters, and using more accessible formats
- Being clearer on exclusions etc on websites (rather than in detailed documents)
- Reviewing fees with fair value in mind
- Use of data to assist in analysis of what services look like to clients
- An overall shift in culture and practice – but “not once and done”

What is next for firms?

- The Duty needs to stay central to culture and purpose, and become part of strategy, leadership and people policies
- Firms need to go back to their implementation plans
    - Did we do what we said we would do?
    - How do we know?
    - Did we go far enough?
- Reminder of deadline for closed policies (31 July 2024)

What is next for the FCA?

- Industry surveys and sector letters will continue
- Analysis of complaints data from the FOS
- Driving for an improvement in the statistics from the 2024 Financial Lives survey

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VIEW

- AI in UK Financial Services — What's on the Horizon?
- FCA Issues Warning on Market Soundings
- European Commission Seeks to Exclude Non-Significant Benchmarks From the BMR
- UK Transition Plan Taskforce Launches Full Disclosure Framework
- UK Government Withdraws the Draft Companies (Strategic Report and Directors' Report) (Amendment) Regulations