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PRIVATE BANK BRIEFING

Issues Impacting the Private Bank Sector

Welcome to our quarterly roundup of legal and compliance issues impacting private banks and their clients.

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MiFID II: Latest Developments

ESMA reminds firms on rules of reverse solicitation

In a statement published on 13 January 2021, ESMA reminded firms not established or situated in the EU of the MiFID II requirements on the provision of investment services to retail or professional clients.

ESMA is concerned that since the end of the Brexit transition period, some "questionable practices" by firms around reverse solicitation have emerged. ESMA highlighted that some firms appear to be trying to avoid the MiFID II requirements by inserting general clauses in their terms of business or by using online pop-up "I agree" boxes where clients state that any transaction is executed at the client's own initiative.

ESMA is concerned that since the end of the Brexit transition period, some "questionable practices" by firms around reverse solicitation have emerged.

ESMA reminds firms that where a third-country firm (i.e. UK firm) solicits clients or potential clients in the EU or promotes investment services, it would not be considered as a service provided at the client's own initiative. ESMA confirms that this is the case regardless of any contractual clause or disclaimer purporting to state otherwise and regardless of the person through whom the solicitation or promotion is issued. ESMA also reminds firms that clients or potential clients can be solicited by all types of communication, including press releases, advertising on the internet, brochures, phone calls, or face-to-face meetings.

ESMA highlights that:

- The provision of investment services in the EU without proper authorisation exposes service providers to the risk of administrative or criminal proceedings
- When using the services of investment service providers which are not properly authorised in accordance with EU and Member States' law, investors may lose protections granted to them under relevant EU laws

Private banks should ensure that if they rely on the reverse solicitation exemption to conduct business in the EU, they look carefully at how they conduct these activities.

FCA updated statement on the operation of the MiFID markets regime

The FCA has updated its statement on the operation of the MiFID markets regime. The share trading obligation equivalence decision for Switzerland entered into force on 3 February 2021. As a result, UK firms are now able to meet their obligations under the share trading obligation on Swiss exchanges and UK trading venues are able to offer trading in Swiss shares.

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In the updated statement, the FCA confirms that Swiss shares that resume trading on UK trading venues will be treated as if they are being traded for the first time on a UK trading venue for the purposes of calibrating the pre- and post-trade transparency regime. An estimate will be made of the relevant parameters based on the characteristics of the shares to apply from their first day of trading. These estimates will then be updated after six weeks based on data from the first four weeks of trading in the UK.

The same logic will apply for tick sizes, with an initial estimate updated after six weeks by a calculation based on data from the first four weeks of trading in the UK. These figures may result in different tick sizes than currently apply for trading of these instruments on exchanges in Switzerland. UK trading venues will be allowed to use the minimum tick size that applies in Switzerland if that tick size is smaller than the minimum tick size based on the average daily number of transactions that the FCA publishes through its Financial Instruments Transparency System.

ESMA working paper on MiFID II research unbundling

ESMA has published a working paper analysing the impact of the MiFID II research unbundling provisions on EU sell-side research, following their application on 3 January 2018. Concerns had been raised that the rules could have had detrimental effects, particularly on SMEs, on the availability and quality of research on EU companies, and on company financing conditions.

In summary, ESMA did not find material evidence of these detrimental effects and concluded that the MiFID II research unbundling provisions have neither improved nor worsened the situation.

ESMA confirmed that the research unbundling rules may further evolve in the future.

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FCA MiFID II product governance review

On 26 February 2021, the FCA published a webpage setting out a review of eight asset management firms' implementation of the UK MiFID II product governance requirements. The firms included asset managers with group assets under management ranging from £2 billion to over £100 billion, and the review looked at product governance compliance across the life cycle of one case study product at each firm. The review examined products that launched both after January 2018 (when the UK MiFID II product governance rules came into effect) and before January 2018 (but only those products that subsequently underwent significant changes, triggering compliance with the rules). Premium listed closed ended investment funds should note that the exemption in LR 15.6.6R is only available where the fund does not have any executive directors.

The FCA found that some asset managers were failing to comply with their product governance obligations, which increased the risk of investor harm. As a result, the FCA believes there is "significant scope" for asset managers to improve their product governance arrangements. The FCA will continue to focus on product governance and will undertake further work in this area, which may result in further changes to its rules and guidance.

The FCA acknowledges that for certain authorised fund managers, the UK MiFID II product governance requirements are guidance rather than binding rules, and that these managers are subject to obligations in the Alternative Investment Fund Managers Directive (AIFMD) and Undertakings for the Collective Investment in Transferable Securities (UCITS), as well as elsewhere in the FCA Handbook, to act in their clients' best interests. However, the FCA also states that it expects firms to "carefully consider" the requirements, and that the framework they provide is "important in ensuring that firms act in the best interests of the investors in their funds".

The FCA believes there is "significant scope" for asset managers to improve their product governance arrangements.

Key findings

The FCA's observations include:

Negative target market: One aspect of the target market assessment by asset managers is to consider whether, in addition to setting a positive target market for the product (i.e., who the product is designed for and why), firms are able (but not required) to also set a negative target market (i.e., anyone for whom the product is not suitable). The FCA observed that only one manager had set a negative target market, and that it conflicted with other aspects of the positive target market assessment. Firms are encouraged to ensure that they consider whether the risk/reward profile is consistent with the target market and that any negative target market they do set properly interacts with the positive target market assessment.

Conflicts of interest: The review found that whilst all firms had a conflicts management framework, not all were effective. The FCA reiterated that, as product governance rules are outcomes-focused, having a framework in place without ultimately ensuring that conflicts either do not arise or are properly managed does not meet its expectations.

Scenario and stress testing: Product governance rules require firms to perform scenario analysis to assess the risk of poor outcomes to clients and the circumstances in which they may occur. Managers may already be required to perform stress testing under, for example, UCITS or Packaged Retail and Insurance-based Investment Products (PRIIPs), and the FCA's sample found that all managers were performing some scenario analysis and/or stress testing. However, the FCA noted a varied approach and reiterated that a key aspect of product governance scenario analysis is to assess the product in volatile market conditions and scenarios that may affect how the product performs.

Costs and charges disclosures: The FCA reminded firms to ensure that costs and charges disclosures are fair, clear, and not misleading, and to match the disclosures contained in, for example, UCITS KIIDs.

Diligencing distributors: The review found that firms were not consistently performing due diligence on their distributors in order to be able to fully assess whether they were fit for purpose and, in turn, whether the distributors would ensure that products end up in the hands of the correct target market.

Distributor feedback: In order for managers to perform proper product reviews and provide appropriate management information to their product governance committees, they must receive appropriate feedback from distributors. The FCA noted that all managers faced challenges in obtaining this feedback but stated that managers could do more to challenge their distributors for this information, and that they should record this challenge.

Governance and oversight: Whilst all managers had a committee that oversaw product governance compliance, the FCA observed that the committee role and terms of reference were often poorly defined and that there were limited examples of meaningful challenge. Record keeping was also cited as being poor, and that critically, if firms did not document challenge, decisions, and checks, they were unable to recall what activities had taken place.

The FCA's review serves as a helpful framework against which asset managers can review their product governance policies and procedures, particularly given the FCA's comments that it expects firms for whom the product governance requirements are optional to ensure that they take them into consideration in any event.

Notably, the FCA's review was limited to asset managers offering UK-authorised collective investment schemes that were available to retail investors (i.e., not professional clients or eligible counterparties) through platforms on both an advised and execution-only basis. This means that the population of firms reviewed were less able to rely on the principle of proportionality that is built into the product governance rules. This is because, broadly, the proportionality principle requires firms to implement the product governance rules in a way that is proportionate to the complexity and risk of the product and the sophistication of the client (which tracks their client categorisation under UK MiFID II). It remains to be seen what the FCA's views will be in relation to compliance with the product governance rules in a context in which proportionality can be relied on to a greater extent — such as, for example, the sale of vanilla shares to professional clients in a wholesale markets context. Firms should monitor for any updates to the product governance rules (including whether any such changes apply only to certain products/manufacturers, such as collective investment schemes and managers, or apply more broadly).

Suspension of the RTS 27 best execution reporting obligations

Investment firms are temporarily no longer required to publish quarterly best execution reports. The European Commission has confirmed that the legislative aim of the MiFID II Quick Fix Directive is to suspend the quarterly RTS 27 best execution reporting obligations for two years as of the day following the entry into force of the MiFID II Quick Fix Directive. Therefore, the suspension of the quarterly best execution reports commenced on 27 February 2021 and will apply for two years. Unlike a normal directive, the MiFID II Quick Fix Directive, and more specifically the provision suspending the best execution reporting obligations, was designed to have direct effect and therefore suspends RTS 27 reports immediately.

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The FCA has also confirmed that it is putting in place temporary measures with respect to RTS 27 reports while it consults on these requirements later in the spring. The temporary measures will be in place until the end of the year. As a result, the FCA will not take action against firms who do not produce RTS 27 reports for the rest of 2021. The FCA expects that by the end of 2021, it will have concluded its policy consideration of the future of these reports.

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Brexit: Update

UK-EU Trade and Cooperation Agreement: financial services aspects

On 24 December 2020, a Brexit "deal" was agreed through a UK-EU Trade and Cooperation Agreement (TCA) that sets out the future relationship between the UK and the EU following the end of the Brexit transition period on 31 December 2020. The TCA is light on details regarding financial services, leaving the UK's position largely as expected in this area: UK firms no longer have access to the single market, nor do they have passporting rights from the start of this year. Further, the TCA does not include any provisions on equivalence frameworks.

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The financial services provisions of the TCA are, however, supplemented by a "Joint declaration on financial services regulatory co-operation", which is a non-binding commitment to establish structured regulatory cooperation on financial services. The declaration states that the framework for regulatory cooperation will be set out in a Memorandum of Understanding. The UK and the EU will also discuss how to move forward on both sides with equivalence determinations, without prejudice to each side's unilateral and autonomous decision making process. However, the European Commission made clear that decisions in relation to equivalence frameworks for financial services remain unilateral decisions of each party and are not subject to negotiation, and that the EU will consider equivalence only when it is in the EU's interest.

Interpretation of EU guidelines and recommendations post-Brexit

On 18 December 2020, the PRA published an updated policy statement on its approach to the interpretation of EU guidelines and recommendations post-Brexit. The PRA confirmed that EU guidelines and recommendations have not been onshored, and that from the end of the transition period on 31 December 2020, HM Treasury has deleted the obligation to make every effort to comply with them. However, the PRA expects UK firms to continue to make every effort to comply with existing EU guidelines and recommendations that are applicable as at the end of the transition period, to the extent that these remain relevant. Annexed to the policy statement is a list of guidelines and recommendations that the UK is complying with (along with a list of guidelines and recommendations that the UK is not complying with).

Similarly, the FCA expects UK firms to continue to apply existing EU guidelines and recommendations to the extent that they remain relevant. UK firms will need to interpret the existing EU guidelines and recommendations sensibly, taking into account onshoring changes or other Brexit-related amendments to UK law.

UK firms are not expected to comply with changes made at EU level, which will not automatically apply, nor with new EU guidelines and recommendations issued by EU authorities after the end of the transition period. The UK regulators will monitor any new developments and other non-legislative EU material, and may issue further statements in relation to them.

Call for evidence on the overseas framework

On 15 December 2020, HM Treasury published a call for evidence on the overseas framework, requesting feedback on the UK framework for financial services firms based overseas, including the overseas persons exclusion and the financial promotion restrictions and exemptions.

The call for evidence is intended to be an information-gathering exercise about how the regimes work in practice. HM Treasury will use this information to assess how the regimes measure up against its principles for cross-border services and fit within the UK's regulatory framework, following the UK's departure from the EU. Following the outcome of this call for evidence, HM Treasury is expected to publish its future approach to the overseas regime later in 2021.

Speech by Andrew Bailey: The case for an open financial system

On 10 February 2021, the Bank of England published a speech by its Governor, Andrew Bailey, in which he considered the benefits of a global financial system and discussed the UK's current and future role in it. In the speech, Mr. Bailey outlined areas of rule changes that the UK is considering, including the application of the Basel regime to small banks. He acknowledged that the Basel regime is heavy-duty and complicated when applied to small banks, and revealed that the UK is instead looking at applying a simple but strong framework of rules for small banks that is not internationally active. Mr. Bailey noted that such an approach would not be out of line with the principles and practice of equivalence, and that other countries, such as the US and Switzerland, apply regimes for small banks that have been determined equivalent to the EU in many areas.

PRA Fees and Levies: Holding Company Regulatory Transaction Fees

On 17 March 2021, the PRA published policy statement (PS3/21) on PRA fees and levies: holding company regulatory transaction fees. PS3/21 provides the PRA's final policy following its consultation (CP21/20) in December 2020.

In CP21/20, the PRA set out proposed rules regarding regulatory transaction fees for applications for approval or exemption as a holding company that would result in changes to the Fees Part of the PRA Rulebook. The consultation paper applied to PRA-authorised banks, PRA-designated investment firms, and their parent undertakings, which comprise financial holding companies (FHCs) and mixed financial holding companies (MFHCs), as well as intermediate companies that sit at the top of a sub-consolidation group.

The PRA proposed to make a regulatory transaction fee of £2,500 payable in respect of an application for approval or exemption as a holding company made under section 192Q of FSMA in order to recover the costs to the PRA of assessing each application.

The PRA received no responses to CP21/20 and as such, the new rule came into force on 19 March 2021.

PRA Policy Statement on CRD V (PS26/20)

On 9 December 2020, the PRA published a policy statement (PS26/20) on the implementation of the CRD V Directive in which the PRA provided feedback to responses on the proposals consulted on in CP12/20 and CP17/20.

Feedback to responses: CP12/20

In light of feedback received in relation to CP12/20, the PRA reported that it has amended:

- SS31/15 to include a clarification on group risk add-ons.
- The proposed rules in the Remuneration Part of the PRA Rulebook and the expectations set out in SS2/17 "Remuneration", including the application of deferral and clawback to different categories of material risk takers (MRTs); the treatment of part-year MRTs; the approach to converting other currencies into sterling for the purposes of applying the UK remuneration regime; the definition of branch assets; and firm-wide application of risk adjustments.
- SS34/15 to clarify how firms can comply with the recovery plan reporting requirement when a branch recovery plan is not available.

Feedback to responses: CP17/20

In light of feedback received in relation to CP17/20, the PRA reported that it has amended:

- The period in which the PRA would expect holding companies to submit formal applications for approval or exemption from approval from 3-31 May 2021 to 1-28 June 2021.
- The date of application for the proposed approach to IRRBB from 31 December 2020 to 31 December 2021.
- The Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook relating to: the treatment of commercial margins in the standardised framework to recognise practical challenges in incorporating commercial margins into risk-free rates; the supervisory outlier test (SOT) to require firms to use appropriate shocks for currencies where shocks are not prescribed, rather than require firms to "develop" appropriate shocks; non-maturing deposits (NMDs) to require firms to estimate the core portion of NMDs based on "a sufficiently long period" with an expectation that firms are generally expected to consider the past 10 years but this can be shorter for new and growing firms.

The PRA has also made consequential amendments to the Additional Leverage Ratio Buffer Model Requirements to refer to the O-SII additional leverage ratio buffer instead of the SRB additional leverage ratio buffer, and to reflect changes at the end of the transition period.

Policy statement PS29/20, published on 28 December 2020, contains the final PRA Rulebook instruments, statements of policy, supervisory statements, and templates which were published in near-final form in PS26/20.

The majority of the PRA Rulebook instruments came into force on 29 December 2020, together with the PRA supervisory statements, unless otherwise stated, and statements of policy.

PRA Letter to iNEDs on Issues and Risks for Boards

The PRA has published a letter it sent to independent Non-Executive Directors (iNEDs) following its pilot programme of virtual meetings in October and November 2020 with iNEDs representing about 40 PRA-regulated banks and insurers. The objective of the meetings was to provide an informal opportunity to discuss issues and risks that have featured on board agendas. The letter sets out the key themes raised by the iNEDs:

The effect of the economic downturn on business models: The economic consequences of the COVID-19 pandemic have placed further pressure on firms' profitability as well as on other areas of business.

The pandemic has placed increased pressure on the operational resilience of firms, created greater challenges for the controls environment, and amplified the risks associated with implementing large-scale IT programmes.

Operational resilience in light of the new working environment: Firms, and the industry in general, have adapted well to remote working. However, the pandemic has placed increased pressure on the operational resilience of firms, created greater challenges for the controls environment, and amplified the risks associated with implementing large-scale IT programmes.

Governance and people challenges: Chairs and boards have adapted well to the virtual environment. Some iNEDs reported increased efficiencies (although many iNEDs noted a need for more contact with senior management outside formal meetings) and senior-level recruitment has continued despite the challenges of remote working. However, there were concerns from the iNEDS about remote working carrying on for much longer.

Climate related financial risk: The PRA's active supervisory approach to climate-related financial risk has been well received. Some iNEDs acknowledged that their firms' climate risk work had been de-prioritised during the COVID-19 pandemic, although firms widely recognised it as a key priority, and that managing the effects of the transition to a low carbon environment would be extremely challenging for firms.

Other issues: Wider consequences of the outbreak for firms' business strategies include the effects of the relatively high level of government borrowing, the growing number of vulnerable customers, the financial hardship of younger customers, the impact on post-baby-boomers' pensions, the reputational consequences for insurers, and the support and training of new recruits whose education was disrupted by the pandemic.

Private banks should consider sharing the PRA's letter with their iNEDS and discussing it at their next board meeting.

SSR: Notification Thresholds

On 15 December 2020, HM Treasury announced that it intended to amend the notification threshold under the Short Selling Regulation (SSR) from 0.2% to 0.1% of the issued share capital of an issuer. The Short Selling (Notification Thresholds) Regulations 2021 were published on 6 January 2021 and this amendment entered into force on 1 February 2021.

Under this amendment, the notification threshold for issued share capital of a company that has shares admitted to trading on a UK trading venue (UK Regulated Market as well as a UK MTF) is 0.1%. Under the ESMA decision in March 2020, which was subsequently renewed in June 2020 and September 2020, the scope of the threshold notification only applied to shares admitted to trading on a regulated market

Under this amendment, the notification threshold for issued share capital of a company that has shares admitted to trading on a UK trading venue (UK Regulated Market as well as a UK MTF) is 0.1%.

On 15 March 2021, ESMA published a press release announcing it has decided not to renew its decision to require holders of net short positions in shares traded on an EU regulated market to notify the relevant national competent authority if the position reaches, exceeds or falls below 0.1% of the issued share capital. The decision expired on 19 March 2021.

From 20 March 2021, positions holders will therefore need to send notifications only if they reach or exceed the 0.2% threshold again, while any outstanding net short position between 0.1% and 0.2% will not have to be reported. The decision has expired because ESMA's view is that the current situation in financial markets no longer resembles the emergency situation required by the SSR to maintain the measure. ESMA states that the overall level of net short positions is decreasing across the EU, reducing the risk that selling pressures could initiate or exacerbate potential negative developments connected with the COVID-19 pandemic.

ESMA Guidelines on Outsourcing to Cloud Service Providers

On 18 December 2020, ESMA published its final report on guidelines on outsourcing to cloud service providers (CSPs). The guidelines aim to help firms identify, address, and monitor the risks arising from cloud outsourcing arrangements. The final report follows the publication of a consultation with proposed draft guidelines on 3 June 2020. The guidelines are consistent with (although there are some differences) the EBA's guidelines on outsourcing arrangements, and EIOPA's guidelines on cloud outsourcing.

Respondents to the consultation generally agreed with ESMA's approach towards outsourcing to CSPs. The Feedback Statement in Annex I of the final report provides detailed content of the consultation responses and ESMA feedback.

The guidelines provide firms with guidance on:

- The risk assessment and due diligence that they should undertake on their CSPs
- The governance, organisational, and control frameworks that they should put in place to monitor the performance of their CSPs and how to exit their cloud outsourcing arrangements without undue disruption to their business
- The contractual elements that their cloud outsourcing agreement should include
- The information to be notified to competent authorities

The guidelines are not intended to be prescriptive on the exact form that cloud outsourcing strategies need to take — such strategies may form part of broader IT or outsourcing strategies. ESMA also clarifies in paragraph 14 of the guidelines that the monitoring of the CSP by the firm should be risk-based, with a primary focus on cloud outsourcing arrangements that concern critical or important functions.

The guidelines are not intended to be prescriptive on the exact form that cloud outsourcing strategies need to take - such strategies may form part of broader IT or outsourcing strategies.

As the implementation date of the guidelines falls after the end of the Brexit transition period, the guidelines will not formally apply to firms operating in the UK, although they will apply to in-scope UK firms acting in the EU.

The guidelines apply from 31 July 2021 to all cloud outsourcing arrangements entered into, renewed, or amended on or after this date and in-scope firms should ensure that their existing cloud outsourcing arrangements take the guidelines into account by 31 December 2022.

Asset Protection: Government Response to Consultation on Expanding the Dormant Assets Scheme

On 9 January 2021, the Treasury and Department for Digital, Culture, Media & Sport (DCMS) issued a response to its February 2020 consultation on expanding the dormant assets scheme.

The UK government intends to expand the dormant assets scheme to include the following:

Sector	Asset classes
Insurance and pensions	• Proceeds of life insurance and retirement income policies
Investment and wealth management	• Shares or units in collective investments • Certain investment asset distributions and proceeds
Securities	• Shares and distributions from shares in public limited companies • Proceeds from corporate actions

In particular, the UK government intends to:

- Include within the scope of the dormant assets scheme the proceeds and distribution from dormant shares in public limited companies traded on a UK regulated market or UK multilateral trading facility and unclaimed proceeds from corporate actions, such as takeovers and mergers.
- Define "dormancy", for proceeds and distributions from dormant shares, as where no contact has been made relating to the assets by, or on the instructions of, the owner for 12 years since the date when the owner has been identified as absent; for example, an asset owner whose contact details a firm no longer believes are accurate because post has been returned. For unclaimed proceeds relating to corporate actions, dormancy will be 12 years after the date when the company received the consideration. The legislation will also give participants flexibility to consider other indications of owner engagement.
- Define "eligible participants" more broadly to include any person who provides, holds, manages, safeguards, administers, deals in, issues, or carries out or operates a policy or scheme in relation to an eligible asset, rather than the prescribed list of participants proposed in the consultation.
- Align reclaim values for dormant share proceeds to the value of the shares at the point of transfer to the body administering the scheme, rather than setting them in line with companies' share forfeiture terms as proposed in the consultation. For distributions from dormant shares and unclaimed proceeds from corporate actions, the reclaim values will be the value of the distributions or proceeds at the time they were due plus accrued interest, adjusted for any fees owed.

The UK government will legislate when parliamentary time allows and will consider how best to reflect that, following the transfer of an asset, any liability of participants and other stakeholders, including any liability to meet owner reclaims, is extinguished.

Private banks should take note of the proposed changes and consider how they will need to be integrated into their current dormant asset policies and procedures.

SMCR: PRA Report on the Evaluation of the SMCR

The PRA reviewed the operation of the SMCR against its original objectives and examined whether there have been any unintended consequences. The evaluation, which covered the period from 2019-2020, included evidence from internal and external sources and examined each component of the SMCR (including across the life cycle of firm and supervisory activity). While the evaluation did not look at FCA solo-regulated firms, certain findings will be of relevance to FCA solo-regulated firms, given the extension of the SMCR to them from the end of 2019.

Status of the evaluation

While the report is not a formal consultation and does not set out specific proposals for amending the PRA Rulebook or supervisory statements, it does include follow-up actions and recommendations. The PRA recently welcomed feedback on the issues outlined. Using that feedback, the PRA will consider if there is a case for proposing changes, which, if decided, would follow the usual consultation process. The PRA will also continue to provide firms, individually or at sector level, feedback if it identifies areas in which firms can improve their implementation of the SMCR.

Key findings and themes identified

The evaluation drew upon internal and external sources, which included:

- A review of regulatory data
- A survey of PRA supervisors
- Structured interviews with practitioners, advisers, and supervisors
- A survey of a sample of 140 PRA regulated firms and senior individuals
- A review of external publications

Themes

The PRA identified three key themes, and three follow-up actions and recommendations for each of the themes:

- Holding individuals to account through the SMCR
- Mythbusting and clarifying expectations
- Applying the SMCR to different business models

For more details, see Latham & Watkins' *Client Alert* PRA Publishes Findings on Its Evaluation of the SMCR.

COVID-19: PRA and FCA Update Statement for Dual-Regulated Firms on SMCR

The PRA and FCA have published an update on their expectations for dual-regulated firms in relation to their obligations under the SMCR and the challenges of the COVID-19 pandemic, following their earlier statement in April 2020. At the start of the pandemic, the regulators offered firms some flexibility in relation to the SMCR rules. However, as firms have now had time to adapt, the regulators' expectation is that firms' application of the SMCR rules returns to normal. Private banks should be aware that some of the previously available provisions ended on 7 January 2021.

Notifications about changes to Senior Manager responsibilities

In their previous statement, the regulators recognised that, as a result of COVID-19, "significant changes" to responsibilities under Senior Management Functions (SMFs) may be required due to sickness or other temporary situations, and that firms might need more time to apply the relevant SMCR rules. The regulators also said that they understood that firms may take longer than usual to submit relevant updated Statements of Responsibilities (SoRs), if certain conditions were met.

This provision ended on 7 January 2021. Since most firms have now adapted to the new ways of working, the PRA/FCA expect firms to manage changes to senior management responsibilities as a result of the pandemic, in a way that allows them to continue to meet their obligations under the SMCR, and to submit revised SoRs as normal.

Since most firms have now adapted to the new ways of working, the PRA/FCA now expect firms to manage changes to senior management responsibilities as a result of the pandemic, in a way that allows them to continue to meet their obligations under the SMCR.

Temporary arrangements for SMFs

Both the PRA's and FCA's rules allow individuals to perform SMFs without approval for up to 12 weeks in a consecutive one-year period if their firm experiences an SMF vacancy that is (a) temporary and/or (b) reasonably unforeseen.

The regulators found no evidence that the 12-week rule does not provide sufficient flexibility for dual-regulated firms due to COVID-19, and therefore they do not intend to introduce any additional measures.

Notifications about temporary arrangements

In April 2020, the regulators stated that if firms cannot reallocate an absent SMF's Prescribed Responsibilities (PRs) among their remaining SMFs due to COVID-19, firms can temporarily allocate them to the individual who is acting as interim SMF under the 12-week rule, even if the individuals are, at the time, unapproved as an SMF.

This provision ended on 7 January 2021.

Allocating responsibility for coordinating firms' responses to COVID-19 among SMFs

As before, the regulators do not require firms to designate a single SMF to be responsible for all aspects of their response to COVID-19. Firms should have a clear framework for allocating responsibilities to SMFs for different aspects of their response to the pandemic, in a way that works for the firm. There is no "one-size-fits-all" approach.

For example, where firms have an SMF24 (Chief Operations Function), aspects of their response to COVID-19 may naturally sit with this SMF (i.e. areas such as business continuity, information security and outsourcing). Other aspects of firms' responses to COVID-19 may sit naturally with other SMFs.

The PRA encourages firms to consider how they may respond to unexpected changes to current contingency plans (contingencies upon contingencies), as SMFs might become suddenly, temporarily absent.

As before, the regulators do not require firms to designate a single SMF to be responsible for all aspects of their response to COVID-19.

Furloughing SMFs

General approach

Dual-regulated firms must have individuals performing one of the following combinations of SMFs at all times:

- CEO (SMF1), CFO (SMF2), and Chair of the governing body (CRR firms and Solvency II insurers)
- Head of Overseas Branch (SMF19) (UK branches of third-country banks and insurers)
- Small Insurer Senior Management Function (SMF25) (small, non-Solvency II insurers)
- Head of Small Run-Off Firms (SMF26) (small, run-off insurance firms)

Firms should only furlough individuals performing these SMFs and other SMFs required by the FCA (e.g., Compliance Oversight (SMF16) and Money Laundering Reporting Officer (MLRO) (SMF17)) as a last resort.

The regulators remind firms that if an individual performing one of the mandatory or required SMFs referred to above becomes absent, firms must appoint individuals to continue performing these SMFs so that firms can continue fulfilling their legal and regulatory obligations. If the replacement is temporary, firms can use the 12-week rule to arrange cover.

Other SMFs are not "mandatory" under PRA/FCA rules, so firms have greater flexibility to furlough the individuals performing them.

However, firms should think carefully about the risks and unintended consequences of furloughing non-mandatory SMFs, in particular those who are key to their business continuity during this period.

The regulators highlight that it could be detrimental for a firm to furlough the individual(s) performing the Chief Operations (SMF24), given their responsibility for areas such as business continuity, cybersecurity, and outsourcing.

Firms should think carefully about the risks and unintended consequences of furloughing non-mandatory SMFs, in particular those who are key to their business continuity during this period.

Notifying and recording the furloughing of SMFs

Unless a furloughed SMF is permanently leaving their post, they will retain their approval during their absence and will not need to be re-approved when they return.

However, the regulators remind firms that they must:

- Ensure that furloughed SMFs remain fit and proper upon their return
- Reallocate the responsibilities of furloughed SMFs, including any PRs among their remaining SMFs
- Clearly document the reallocation of responsibilities of any furloughed SMFs in SoRs, Management Responsibility Maps (MRMs), and internal documents

Firms should also update their PRA/FCA supervisors of any furloughing of one or more SMFs by emailing or calling the PRA/FCA.

Certification requirements for dual-regulated firms

Firms should continue to take reasonable steps to complete any annual certifications of employees that are due to expire while COVID-19 restrictions are in place. The regulators expect firms to have now adapted to the restrictions imposed by the pandemic and to complete these certifications on time.

Firms should continue to take reasonable steps to complete any annual certifications of employees that are due to expire while COVID-19 restrictions are in place.

COVID-19: FCA Newsletter Market Watch 66

On 11 January 2021, the FCA published Market Watch 66, setting out its expectations for firms on recording telephone conversations and electronic communications when alternative working arrangements are in place, including homeworking, in light of the COVID-19 pandemic.

Risk from reduced monitoring

The FCA recognises that the pandemic has had a significant, and in some cases long lasting, effect on how businesses are run, with changes to technology and increased homeworking. However, the FCA emphasises that it expects firms to continue to comply with the recording obligations under SYSC 10A, which remain unchanged.

The FCA recognises that the pandemic has had a significant, and in some cases long lasting, effect on how businesses are run, with changes to technology and increased homeworking.

The FCA highlights that there is an increased risk of misconduct from homeworking, including employees using unmonitored and/or unencrypted communications applications such as WhatsApp to share potentially sensitive information. The FCA reminds firms that they must ensure that apps used for in-scope activities on business devices are recorded and auditable.

The FCA also reminds firms that it has acted against individuals and firms for misconduct involving the use of WhatsApp and other social media platforms to arrange deals and provide investment advice.

The FCA highlights that there is an increased risk of misconduct from homeworking, including employees using unmonitored and/or unencrypted communications applications such as WhatsApp to share potentially sensitive information.

Communications that must be recorded

The recording obligations apply to conversations and communications made with, sent from, or received on equipment provided or permitted to be used for business purposes.

The FCA emphasises that firms who are subject to the recording regime must take reasonable steps to record telephone conversations, and keep a copy of electronic communications of activities that fall within the scope of the recording rules.

Private banks should ensure that their recording policies can identify calls and communications that directly relate to the performance of an in-scope activity or that are intended to lead up to these activities, including, depending, on the circumstances, internal conversations.

Robust firms

The FCA reminds firms that they must have effective, up-to-date recording policies and they must be able to demonstrate, on request, that their policies, procedures, and management oversight meet the recording rules. This includes policies and procedures adopted for home working arrangements. The FCA suggests that firms could also introduce policies banning the use of privately owned devices for in-scope activities if recording cannot be carried out. In all cases, arrangements should be clear that new communication mediums must be approved by the firms before being used by employees to conduct business activities.

Training

Firms should provide appropriate training to staff if they introduce new or amended policies or technologies.

In summary, whilst there is no restriction on the technologies or apps firms can use for communications, private banks should ensure that they understand the recording obligations and have effective policies, controls, and oversight to ensure that these obligations are met.

Sustainable Finance Update

UK Announces its ESG Agenda

FCA Enhances Climate-Related Disclosures for Listed Companies

On 21 December 2020, the FCA confirmed in a published Policy Statement (the Statement) that it will introduce a new Listing Rule (the Rule) requiring premium listed companies to state whether they have made disclosures pursuant to the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, and if not, why.

The Rule is a forerunner to the UK's plan to fully align corporate disclosure with the TCFD by 2025. The Statement sets out that "better disclosure about organisations' exposure to climate change risks and opportunities will lead to more informed pricing and drive investment towards greener projects and activities", helping support net zero emissions ambitions. The FCA is hopeful that the implementation of TCFD-aligned disclosures will pave the way for an eventual international standard for corporate reporting that is also integrated with financial reporting.

The Rule

The Rule (LR 9.8) will apply for accounting periods beginning on or after 1 January 2021. It will require companies with a UK premium listing to include a statement in their annual financial report setting out:

- Whether they have made disclosures consistent with the TCFD recommendations
- An explanation if they have not made disclosures consistent with some or all of the TCFD recommendations
- Whether they have included some, or all, of their disclosures in a document other than their annual financial report, alongside an explanation of why
- Where in their annual financial report (or other relevant document) the various disclosures can be found

The Rule will be accompanied by guidance aimed at helping listed companies determine whether their disclosures are consistent with the TCFD recommendations.

The FCA also announced its intention in 2021 to consult on TCFD-aligned rules for a wider scope of listed companies, as well as asset managers, life insurers, and FCA-regulated pension schemes.

EU ESG Agenda: Latest Developments

Sustainable Finance Disclosure Regulation

On 4 February 2021, the European Supervisory Authorities (ESAs) published a final report that sets out the Sustainable Finance Disclosure Regulation (SFDR) Level II measures and the associated implementation timings. Firms in scope of the SFDR now have the relevant entity and product level templates to make SFDR-aligned disclosures. These requirements are summarised in the tables on the following pages:

	FMP	FA	Level I 10 Mar 2021	Level II RTS 1 Jan 2022	Level I 30 Dec 2022
Corporate Level ***Publish on website***	●	●	**(Art 3) Sustainability Risk Management Policy**		
	●	●	**(Art 4) Principal Adverse Impact Statement** a. Information about their policies on the identification and prioritisation of principal adverse sustainability impacts and indicators b. A description of the principal adverse sustainability impacts and of any actions in relation thereto taken or, where relevant, planned c. Brief summaries of Stewardship/ CSR Policy	A **mandatory reporting template**: • Sustainability indicators in relation to adverse impacts on the climate and other environment-related adverse impacts • Sustainability indicators in relation to adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters **To note:** • 15 mandatory indicators and more opt-in indicators • Separate indicators for investments in sovereigns (and supranationals) and real estate assets • Consider PAI through "all reasonable means available"— "a best effort to obtain the information either directly from investee companies, or by carrying out additional research, cooperating with third party data providers or external experts or making reasonable assumptions" • PAI metrics calculations to be undertaken on at least four specific dates during the year and accompanied by a historical year-by-year comparison • Obligation to disclose how the engagement policies adapt where "there is no reduction of the principal adverse impacts over more than one reference period" • The first reference period should run from 1 January to 31 December 2022, with the first report to be published in 2023 • Prescribed statement when not considering principal adverse impacts	
	●	●	(Art 5) **Remuneration Policy**		

	FMP	FA	Level I 10 Mar 2021	Level II RTS 1 Jan 2022	Level I 30 Dec 2022
Product / Service Level ***Publish on website***	●	●	**(Art 10) Promotion of environmental or social characteristics (Art 8) and of sustainable investments (Art 9)** For each ESG product: a. A description of the investment objective; b. Methodologies used; c. The information included in the pre-contractual disclosures; d. The information referred to in the periodic reports	For each product, information in relation to **12 different data points** describe the environmental or social characteristics of financial products or the sustainable investment and the methodologies used. This includes the need to publish a two-page summary. To note: the disclosure of direct versus indirect investments has been moved from pre-contractual and periodic disclosures to the website disclosures.	Information on performance of products against sustainability objectives

	FMP	FA	Level I 10 Mar 2021	Level II RTS 1 Jan 2022	Level I 30 Dec 2022
Product / Service Level ***Pre-contractual disclosures***	●	●	**(Art 6) Pre-contractual disclosures** covering: (1) How are sustainability risks embedded; (2) The result of sustainability risk assessment process; (3) Specific disclosures for products with the following objectives	The policy approach chosen for the pre-contractual granularity of information is of minimum standardisation of requirements, which includes mandatory templates while allowing for some tailoring of the approach to specificities of financial products: **Mandatory template** List of items to be included in the reporting indicating clearly the type of product and how the environmental or social characteristic (or combination thereof) or the sustainable investment objective of the product are achieved Additional items of disclosure where the product designates an index as a reference benchmark Requirements for products making sustainable investments regarding how the product complies with the "do not significantly harm" principle	FMPs: Whether and how a product considers principal adverse impacts on sustainability factors
	●		**(Art 8) Environmental/social characteristics**	A **mandatory reporting template** How a product with environmental or social characteristics meet those characteristics and if an index has been designated as a reference benchmark, whether and how that index is consistent with those characteristics	
	●		**(Art 9) Sustainable investment**	A **mandatory reporting template** Where a product has sustainable investment objectives and a) has a designated index as a reference benchmark, how that index is aligned with the sustainable investment objective and an explanation as to why and how that designated index aligned with the objective differs from a broad market index; or b) if no index has been designated as a reference benchmark, an explanation on how those objectives are to be attained	
	●		**(Art 9) Reduction of carbon emissions**	A **mandatory reporting template**	

	FMP	FA	Level I 10 Mar 2021	Level II RTS 1 Jan 2022	Level I 30 Dec 2022
Product / Service Level ***Periodic reports***	●			**Level 1: (Art 11) Periodic reports** **(Art 8)** products - the extent to which environmental or social characteristics are met **(Art 9)** products: • The overall sustainability-related impact of the financial product by means of relevant sustainability indicators; or • Where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators. **Level II RTS: Mandatory reporting template(s)** for Art 8 and Art 9 products Requirements for products making sustainable investments regarding how the product complied with the "do not significantly harm" principle in relation to the principal adverse impact indicators	
Marketing literature	●	●	**(Art 13)** Ensure that marketing communications do not contradict the information disclosed pursuant to SFDR		

EU Taxonomy Regulation – Article 8

On 26 February 2021, both ESMA and the EBA issued guidance on Article 8 of the EU Taxonomy Regulation. Firms in scope of the EU Taxonomy Regulation now have all the relevant guidance to start planning their disclosures on how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable under the EU Taxonomy Regulation.

The guidance elaborates on the Key Performance Indicators (KPIs) that institutions should disclose, the scope and methodology for the calculation of those KPIs, and the qualitative information that institutions should provide.

The main KPI proposed is the Green Asset Ratio (GAR), which identifies institutions' asset financing activities that are environmentally sustainable according to the EU Taxonomy Regulation, including activities consistent with the goals of the European Green Deal and the Paris Agreement. Information on the GAR is supplemented by other KPIs that provide information on the taxonomy-alignment of institutions' services other than lending and investing. The EBA has integrated proportionality measures that should facilitate institutions' disclosures, including transitional periods where disclosures in terms of estimates and proxies are allowed.

The main KPI proposed is the Green Asset Ratio (GAR), which identifies institutions' asset financing activities that are environmentally sustainable according to the EU Taxonomy Regulation.

The EU Taxonomy Regulation takes effect on the following dates:

- **1 January 2022** (with disclosure reference date end 2021): for the environmental objectives of climate change mitigation and climate change adaptation
- **1 January 2023** (with disclosure reference date end 2022): other environmental objectives (sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems)

ESG risk disclosures under the CRR

The EBA is consulting on prudential disclosures of ESG risks under Article 449a of the Capital Requirements Regulation (CRR) as part of the Pillar 3 reporting framework, currently designed for disclosure of regulatory capital and risk exposures. The proposals are intended to allow investors and stakeholders to compare the sustainability performance of institutions, with a spotlight on their financial activities and vulnerabilities, and how they are mitigating ESG risks, including information on how they are supporting their customers and counterparties in the adaptation process. The Pillar 3 disclosures work in parallel to Article 8 of the EU Taxonomy Regulation and the EBA advice under Article 8 of the EU Taxonomy Regulation should therefore be read in conjunction with this consultation paper.

The proposals are intended to allow investors and stakeholders to compare the sustainability performance of institutions, with a spotlight on their financial activities and vulnerabilities, and how they are mitigating ESG risks.

The EBA is proposing a sequential approach for the implementation of prudential ESG disclosures. This approach falls in line with the deadlines that the European Commission has planned for the EU Taxonomy Regulation, which by the end of 2022 covers only the screening criteria related to the environmental objectives of climate change mitigation and climate change adaptation. Once the taxonomy screening criteria is extended to cover other environmental objectives, the EBA will then extend the draft Pillar 3 ESG implementing technical standards (ITS) to implement quantitative disclosures on other environmental risks and objectives. By the end of 2021, the Commission will report on whether to extend the scope of the taxonomy to social risks and to environmentally harmful and neutral activities, an extension that the EBA would very much support, as it would provide additional and relevant tools to institutions. If the taxonomy is extended to cover environmentally harmful and neutral activities, the EBA will revise the quantitative information proposed in the draft ITS in order to align it with the taxonomy definitions and classification criteria.

1. Quantitative information on climate change-related risks, including transition and physical risks

- Transition risk - exposures towards sectors that highly contribute to climate change, with a breakdown on the one hand of exposures towards fossil fuel and other carbon-related sectors and on the other hand of taxonomy aligned exposures. This information is combined with information on scope 3 emissions per sector
- Physical risk - exposures towards sectors and geographies exposed to climate change events linked to physical acute and chronic risks, and a disclosure template including this information is included for consultation

2. Quantitative information on other mitigating actions

Climate change-related risks, including information on taxonomy-aligned actions (GAR) and on other mitigating actions

3. Qualitative disclosures on institutions' strategy, governance and risk management framework regarding ESG risks

- Three tables that specify the disclosure requirements on qualitative information related to ESG risks
- Covers ESG risks that may manifest on institutions' balance sheets from the impact of ESG factors and risks on their counterparties through main transmission channels (including physical and transition channels)

Coverage of disclosures to align with Taxonomy timeline

Climate Change → Other Environmental Risks → Social & Governance Risk

The Pillar 3 disclosures will be required from 28 June 2022 (for CRR firms) and 26 December 2022 (for IDD Class 2 firms). Transitional arrangements are in place as follows:

- **June 2024:** disclosures on institutions' scope 3 emissions

Rationale: Institutions will need to collect information on CO_2 emissions from their counterparties and develop methodologies to estimate their scope 3 emissions. During the transitional period, institutions will explain the methodologies they are developing to measure and estimate their scope 3 emissions and the sources of data they plan to use. Institutions that are already estimating this information should start disclosing it, using estimates and ranges.

- **June 2024:** disclosure of the GAR on stock of assets for those exposures towards retail and corporates not subject to the Non-Financial Reporting Directive (NFRD) disclosure obligation

Rationale: The data collection process should be easier and faster in the case of counterparties that are subject to NFRD disclosure obligations, as they will start disclosing relevant information for the 2021 financial year from January 2022 under Article 8 of the EU Taxonomy Regulation. It will be more burdensome for counterparties not subject to the NFRD — in that case, information will be collected on a bilateral basis. The transition date is aligned with the deadlines included in the EBA Guidelines on loan origination and monitoring.

Firms in scope of the EU regulations have a number of different overlapping entity level ESG disclosures to make:

		TCFD Guidelines	Non-Financial Reporting Directive	EU Taxonomy Regulation	CRR 2 & CRD 5 Pillar 3 Disclosures	IFD & IFR
Entities in scope		Voluntary Global Standards (Becoming **mandatory in multiple geographies including the UK**)	**1. EU Corporates** 500+ employees EU listed instruments Or other companies designated by NCAs are "public interest companies" **2. EU Banks** **3. EU Insurers**	**1. Corporate in scope of NFRD (including financial institutions)** **2. Financial Market Participants**	**1. Large financial institutions which have issued securities that are admitted to trading on any regulated market in the EU**	**1. Class 2 investment firms (i.e. firms subject to the full prudential requirements set out in the IFR and IFD)**
Snapshot		TCFD is a private sector task force with recommendations that are widely recognised as authoritative guidance on the reporting of financially material climate-related information	NFRD sets out disclosure rules in relation to ESG data, to the extent that such information is necessary for an understanding of the company's development, performance, position, and impact of its activities	Codification system against which companies are required to disclose the extent to which their activities are aligned with the Taxonomy's sustainability metrics	Requires disclosure of prudential information on environmental, social, and governance risks, including transition and physical risk	
E	**Climate**	Yes	**Yes**	Yes	Yes	Yes
	Other		**Yes**	Yes	Yes	Yes
S			**Yes**		Yes	Yes
G			**Yes**		Yes	Yes

PRIIPS: Agreement on Changes to the PRIIPs KID

On 3 February 2021, the European Supervisory Authorities (ESAs) submitted to the European Commission draft Regulatory Technical Standards (RTS) on amendments to the PRIIPs Key Information Documents (KIDs).

In December 2020, the Commission invited the ESAs to submit an RTS to amend the KID within a six-week period. The European Insurance and Occupational Pensions Authority (EIOPA) further analysed these draft RTS which they adopted on 3 February 2021 by a qualified majority of EIOPA's Board (having previously been rejected). EIOPA's press release explains that while some national competent authorities on EIOPA's Board of Supervisors continued to express reservations on the draft RTS, they supported the proposal based on the further details provided by the Commission on its approach to the broader review of PRIIPs Regulation and its assurances that the review would thoroughly examine the application of the PRIIPs framework, including:

- Achieving better alignment between PRIIPs, the Insurance Distribution Directive, and MiFID II regarding provisions on costs disclosures
- Analysing the scope of products within the scope of the PRIIPs Regulation
- Ensuring that the KID contains the key information necessary for retail investors while avoiding too much information or information that is too complex for these investors
- Allowing the creation of a digitalised KID allowing layered information and reviewing the default paper basis of the KID, taking into account the specific challenges for different types of products (e.g., multi-option products)
- Assessing the need for a more tailored approach for products such as multi-option products in order to maximise understanding and use of the information, while continuing to allow for comparability of similar products

Private banks should monitor this proposed amendment as it progresses through the legislative process to see whether and what changes will ultimately be made to the PRIIPS KID regime, and whether similar changes will be adopted in the UK.

LIBOR: FCA Confirms Dates for Cessation of LIBOR Benchmarks

On 5 March 2021, the FCA formally announced the dates for the cessation of all LIBOR benchmark settings currently published by the IBA. The FCA also confirmed that where a "synthetic" LIBOR is available after the cessation dates, the synthetic LIBOR will not in any event be considered to be representative as of the cessation dates. This is an important step towards the end of LIBOR, providing market participants with a fixed timeline for LIBOR's cessation. The announcement also adds pressure on market participants to complete their transition plans by the end of 2021.

This is an important step towards the end of LIBOR, providing market participants with a fixed timeline for LIBOR's cessation.

The FCA's announcement follows the IBA's notification to the FCA — following its consultation and notices of future departure received from the majority of the panel banks for each LIBOR setting — that it intends to cease providing all LIBOR settings for all currencies, subject to any rights of the FCA to compel IBA to continue publication.

ISDA confirmed that the FCA's announcement will serve as a trigger event for the application of fallbacks under its IBOR Fallbacks Supplement and Protocol.

FCA announcement

The FCA confirmed that publication of 26 LIBOR settings will **cease immediately after**:

- **31 December 2021** for all seven euro LIBOR settings; all seven Swiss franc LIBOR settings; the Spot Next, 1-week, 2-month, and 12-month Japanese yen LIBOR settings; the overnight, 1-week, 2-month, and 12-month sterling LIBOR settings; and the 1-week and 2-month US dollar LIBOR settings
- **30 June 2023** for the overnight and 12-month US dollar LIBOR settings

The FCA does not expect that any LIBOR settings will become unrepresentative before the specified dates. However, representative LIBOR rates will not be available beyond the confirmed cessation dates. Publication of most of the LIBOR settings will cease immediately after these dates.

In addition, for the remaining nine LIBOR settings the FCA has announced that it will:

- Consult on whether the three remaining sterling LIBOR settings (1-month, 3-month, and 6-month) should continue to be published **for a further period** after 31 December 2021 on a synthetic basis, using the FCA's proposed new powers that the UK government is legislating to grant it under the UK Benchmarks Regulation (UK BMR)
- Consult on whether the Japanese yen LIBOR settings (1-month, 3-month, and 6-month) should continue to be published after 31 December 2021 on a synthetic basis, until **31 December 2022**, when these settings would permanently cease
- Continue to consider the case, as the transition away from US dollar LIBOR progresses, to require continued publication on a synthetic basis of the US dollar LIBOR settings (1-month, 3-month, and 6-month) **for a further period** after 30 June 2023

Libor Currency	Ice Administration Ceasing In Current Form	Potential For A Synthetic Libor For Tough Legacy Contracts?
GBP	31 December 2021	Possible for 1-month, 3-month, and 6-month settings only
USD: 1-week and 2-month US dollar LIBOR	31 December 2021	No
USD: all other settings	30 June 2023	Subject to future FCA consideration
YEN	31 December 2021	Possible for 1-month, 3-month, and 6-month settings only
EURO	31 December 2021	No
SWISS FRANC	31 December 2021	No

The FCA is due to consult later in 2021 on its proposed new powers that the UK government is legislating to grant it under the UK BMR to require the IBA to continue publishing the LIBOR settings mentioned above on a synthetic basis.

However, the extended publication of certain LIBOR settings on a synthetic basis will only provide relief for certain types of tough legacy contracts (contracts that are particularly difficult to renegotiate or amend or where there is no suitable alternative), and must not be used in new contracts. As such, the FCA's proposed new powers are likely to be of limited use to the wider market. The FCA is expected to consult in the second half of 2021 on which categories of tough legacy contracts will be permitted to use any synthetic LIBOR rate.

ISDA announcement

ISDA confirmed that the FCA's announcement of 5 March 2021 "constitutes an index cessation event under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol for all 35 LIBOR settings. As a result, the fallback spread adjustment published by Bloomberg is fixed as of the date of the announcement for all euro, sterling, Swiss franc, US dollar and yen LIBOR settings", providing more clarity for holders of legacy derivatives contracts.

ISDA also issued additional guidance on the FCA announcement.

The FCA's proposed new powers under the UK BMR

The FCA has published statements of policy in relation to some of its proposed new powers under the UK BMR. These statements of policy confirm the FCA's policy approach, explain the FCA's plans and intention to propose using, as a methodology for any synthetic rate, a forward-looking term rate version of the relevant risk-free rate plus a fixed spread aligned with the spreads in ISDA's IBOR fallbacks.

The announcements by the FCA and ISDA mark the end of LIBOR and confirm the importance of preparations for private banks transitioning away from LIBOR.

Next steps

Private banks must act now. The announcements by the FCA and ISDA mark the end of LIBOR and confirm the importance of preparations for private banks transitioning away from LIBOR. Private banks should expect further engagement from their supervisors at the PRA and the FCA to help them meet the specified deadlines.

Nikhil Rathi, CEO of the FCA, emphasised that the announcements "provide certainty on when the LIBOR panels will end … Market participants must now complete their transition plans".

Diversity: Why the FCA Cares About Diversity and Inclusion

Georgina Philippou, Senior Adviser to the FCA on the Public Sector Equality Duty, delivered a speech at the Ethnic Diversity in the City and Corporate UK Summit in which she provided some interesting insights into diversity and inclusion in the financial services sector and the importance of the FCA leading by example.

Ms. Philippou commented that "financial services generally are not diverse and inclusive and that cannot be a good thing for anyone". She also highlighted that the FCA "wants to see a healthy financial services industry with cultures that reduce the potential for harm" as well as the FCA wanting to "mainstream diversity and inclusion into all of [the FCA's] regulatory processes". Remarking that it is common knowledge that diversity has many benefits, Ms. Philippou reminded firms that people with different life experiences bring new ways of thinking and can inspire new approaches to problem solving and decision making.

Ms. Philippou highlighted that the McKinsey "Diversity Wins" Report, published in May 2020, found that the most ethnically diverse companies are 35% more likely to outperform the least diverse companies. However, the "Green Park Leadership 10,000" annual report in 2019 found that only 1.6% of the Top 100 roles in Finance & Banking FTSE 100 companies are held by Black colleagues. With members of the Black, Asian, and Minority Ethnic (BAME) community holding fewer than 1 in 10 management jobs in UK financial services, despite the fact that 2018 census figures indicate that 40% of the London population is BAME, this underlines the lack of diversity in the UK financial services industry.

It is the responsibility of everyone in the financial services industry, to create and maintain cultures which embody diversity and inclusion.

How a firm prioritises and embeds diversity and inclusion are clear indicators of its culture. As each firm's culture is different, there is no "one-size-fits-all" model and the FCA cannot tell a firm what its culture should be. Instead, it is the responsibility of everyone in the financial services industry, to create and maintain cultures which embody diversity and inclusion.

Ms. Philippou set out the four key drivers that the FCA believes embed a healthy culture within a firm:

1. A meaningful purpose
2. An appropriate governance structure to facilitate good decision making
3. Effective leadership including the tone from the top
4. People policies that incentivise behaviours that create an inclusive environment

Ms Philippou also emphasised the importance of firms creating an environment where employees feel safe to share ideas and speak up. The behaviour and actions of Senior Managers are also key to influencing and supporting a safe and inclusive environment.

Not only do people need to be able to "speak up", but Senior Managers need to "listen up" when they do.

Not only do people need to be able to "speak up", but Senior Managers need to "listen up" when they do. When employees do speak out, a firm's response is key as to whether they or their colleagues will feel safe to speak out again. Therefore, a firm's culture should encourage both speaking and listening up.

Private banks should note the importance the FCA is placing on diversity and inclusion, both as an employer and as a regulator, and look at ways in which banks can promote this in their policies and processes.

Private banks should note the importance the FCA is placing on diversity and inclusion, and look at ways in which banks can promote this in their policies and processes.

FCA Guidance for Firms on the Fair Treatment of Vulnerable Customers

The FCA has published guidance setting out its expectations of firms on the fair treatment of vulnerable customers. The guidance aims to drive improvements in the way firms treat vulnerable consumers so that those consumers are consistently able to achieve outcomes that are as good as those of everybody else. Private banks should understand what harms their customers are likely to be vulnerable to and ensure that customers in vulnerable circumstances can receive the same fair treatment and outcomes as other customers. This needs to happen through the whole customer journey, from product design to customer engagement and communications.

The guidance aims to drive improvements in the way firms treat vulnerable consumers so that those consumers are consistently able to achieve outcomes that are as good as those of everybody else.

This guidance applies to all firms where the FCA's Principles for Businesses apply, regardless of sector. The guidance also applies to the supply of products or services to retail customers who are natural persons, even if a firm does not have a direct client relationship with the customer. The FCA defines a vulnerable customer in the guidance as someone who, "due to their personal circumstances, is especially susceptible to harm, particularly when a firm is not acting with appropriate levels of care".

This needs to happen through the whole customer journey, from product design to customer engagement and communications.

The FCA highlights that to achieve good outcomes for vulnerable customers, firms should:

- Understand the needs of their target market/customer base, including understanding the:
  - Nature and scale of characteristics of vulnerability that exist in their target market and customer base
  - Impact of vulnerability on the needs of consumers in their target market and customer base, by asking themselves what types of harm or disadvantage their customers may be vulnerable to, and how this might affect the consumer experience and outcomes
- Ensure their staff have the right skills and capability to recognize and respond to the needs of vulnerable customers, including:
  - Embedding the fair treatment of vulnerable consumers across the workforce; all relevant staff should understand how their role affects the fair treatment of vulnerable consumers
  - Ensuring frontline staff have the necessary skills and capability to recognise and respond to a range of characteristics of vulnerability
  - Offering practical and emotional support to frontline staff dealing with vulnerable consumers
- Respond to customer needs throughout product design, flexible customer service provision and communications:
  - Consider the potential positive and negative impacts of a product or service on vulnerable consumers. Design products and services to avoid potential harmful impacts.
  - Take vulnerable consumers into account at all stages of the product and service design process, including idea generation, development, testing, launch, and review, to ensure products and services meet their needs.
  - Set up systems and processes in a way that will support and enable vulnerable consumers to disclose their needs. Firms should be able to spot signs of vulnerability.
  - Deliver appropriate customer service that responds flexibly to the needs of vulnerable consumers.
  - Make consumers aware of support available to them, including relevant options for third party representation and specialist support services.
  - Implement systems and processes that support the delivery of good customer service, including systems to note and retrieve information about a customer's needs.
  - Ensure all communications and information about products and services are understandable for consumers in their target market and customer base.
  - Examine how they communicate with vulnerable consumers, taking into consideration their needs. Where possible, firms should offer multiple channels, so that vulnerable consumers have a choice.
- Monitor and assess whether they are meeting and responding to the needs of consumers with characteristics of vulnerability, and make improvements where this is not happening:
  - Implement appropriate processes to evaluate where they have not met the needs of vulnerable consumers, so that they can make improvements.
  - Produce and regularly review management information, appropriate to the nature of their business on the outcomes they are delivering for vulnerable consumers.

The guidance sets out ways in which firms can comply with their obligations under the Principles for Businesses in order to treat vulnerable consumers fairly. It does not provide a checklist of required actions and will apply to firms in different ways because of the significant differences across and within sectors. Private banks will need to use their judgment to decide precisely what the guidance means for them. Relevant factors include the specific context of each private bank, including its size, the markets it operates in, the products it offers, and the characteristics of its target market and customers.

The FCA confirms that while the guidance only applies to firms' dealings with retail customers who are natural persons, firms should remember that the Principles, including the obligation to treat customers fairly, extend to all customers. Firms may therefore find this guidance helpful when considering how to comply with their obligations under the Principles for Businesses for incorporated businesses (e.g., when dealing with a representative of an incorporated business who has characteristics of vulnerability).

Kalifa Review

Ron Kalifa OBE has drafted an independent report on the direction of HM Treasury about how the UK can retain and strengthen its global position in financial innovation by accelerating investment in the fintech sector. Mr. Kalifa notes that "While the UK's position is well established, its future is not assured".

Mr. Kalifa outlined three current, broad threats to the UK's leadership position in the fintech sector:

- Competition – increased competition from overseas jurisdictions such as Singapore, Australia, and Canada
- Brexit – regulatory uncertainty in specific areas related to fintech created by Brexit
- COVID-19 – accelerated "digital adoption" as a result of the pandemic

According to the report, the "prize" lies in three opportunities: an increase in tech-based jobs; trade and greater access to international markets; and inclusion and recovery by supporting access to more, better, and cheaper financial services.

Five-Point Action Plan

The review sets out recommendations around five key themes:

- Policy and Regulation – dynamic leadership that protects consumers yet nurtures fintech activity and encourages competition
- Skills – ensuring the fintech industry has a sufficient supply of domestic and international talent and the means to train and upskill the UK's current and future workforce
- Investment – completing the funding ladder from startups right through to IPO
- International – a targeted approach to exports and inward investment
- National connectivity – leveraging the output of fintech companies across the UK and facilitating connectivity amongst them

Policy and Regulation

The report proposes the creation and implementation of a new fintech policy and regulatory strategy for the UK. The proposals include:

- Delivering a digital finance package that creates a new regulatory framework for emerging technology
- Implementing a "Scalebox" that supports the growth of firms focusing on innovative technology, including enhancing the Regulatory Sandbox, making the digital sandbox pilot permanent, introducing measures to support partnering between incumbents and fintech/reg tech firms, and providing additional support for regulated firms in the growth phase
- Establishing a Digital Economy Taskforce (DET): Multiple departments and regulators have important fintech competencies and functions and the DET would be responsible for collating this into a policy roadmap for tech and digital, in particular, the digital finance package
- Securing the fintech industry's position as an integral part of the UK's trade policy
- The CMA adapting its approach to the fintech sector in order to better balance competition and growth

Investment

The report proposes improving the listing environment by:

- Reducing free float requirements on the Premium segment from 25% to 10%, for a limited time post-IPO; or implementing a minimum threshold
- Enhancing governance rights – a golden share or dual class share structures
- Maintaining the relaxation of pre-emption rights

Mr. Kalifa highlighted that the relaxation of listing requirements would attract more fintech companies to explore the UK's public listings.

Other investment recommendations include creating a global family of Fintech Indices. This would improve understanding and enhance visibility of the sector, as well as attract index tracking hedge funds and investors. The report also proposes creating a Fintech Growth Fund to act as the catalyst in developing a world-leading ecosystem to support the growth of fintech companies.

The government will now review the recommendations in the report "in detail".

BMR: Regulation Amending BMR to Address Benchmark Cessation Risks and Exempt Certain Third-Country FX Benchmarks

The Regulation amending the EU Benchmark Regulation (EU BMR) as regards the exemption of certain third-country foreign exchange (FX) benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation entered into force and applied from 13 February 2021.

Under the amended EU BMR, the European Commission has the power to replace so-called "critical benchmarks", which could affect the stability of financial markets in the EU, and other relevant benchmarks, if their termination would result in a significant disruption in the functioning of financial markets in the EU. The Commission is also able to replace third-country benchmarks if their cessation would result in a significant disruption in the functioning of financial markets or pose a systemic risk for the financial system in the EU.

In addition, the amendments extend the transitional period for the use of third-country benchmarks by regulated EU users until the end of 2023, with the option for the Commission to extend this period until the end of 2025 provided that such an extension is adopted in a delegated act by 15 June 2023. The Commission also has the power to exempt certain third-country benchmarks from the scope of the EU BMR; separate decisions on a benchmark-by-benchmark basis will be made in relation to this.

Private banks should note that this amending Regulation has not been onshored in the UK, which has already extended the third-country transitional regime under the UK BMR to the end of 2025. However, where private banks provide indices into Europe, the extension of the third-country transitional regime for EU users will allow this provision to continue until the end of the transitionals, without the need for endorsement or recognition in the EU.

Lessons from Enforcement: Breaching Principle 11 — The implications of the FCA's Final Notice to Charles Schwab UK

Breaching Principle 11: The implications of the FCA's Final Notice to Charles Schwab UK

The FCA's 21 December 2020 Final Notice to Charles Schwab UK Limited (CSUK) is interesting not because of the breaches of the CASS Rules that accounted for the bulk of the £8,963,200 penalty imposed on CSUK (after applying a 30% discount for early settlement), but because of the FCA's finding that CSUK breached Principle 11 (P11).

The facts can be summarised succinctly. CSUK was originally a referral business, passing UK- and Switzerland-based clients to another part of the Charles Schwab Group, CS&C. CSUK began holding client money and safeguarding and administering assets in its own right in 2017. A gap analysis carried out prior to this change identified only one change relating to CASS: namely, the opening of a UK bank account for the deposit of cheques. But, according the Final Notice, CSUK overlooked the requirements of Principle 10 to arrange adequate protection for client assets by failing to maintain its own records and accounts and simply continuing the pre-existing arrangement by which client monies and assets were swept (in accordance with an outsourcing agreement) into accounts maintained by CS&C. There was therefore a risk to clients in the event of an insolvency. Further, CSUK (a) failed to carry out client asset and money reconciliations or custody record checks; (b) did not have adequate organisational arrangements in respect of custody assets or client money; (c) did not have suitable monitoring and oversight of CS&C's outsourced activities for a time; and (d) did not have a documented CASS risk assessment or a CASS resolution pack for a time.

So far, so (relatively) familiar. The CASS Rules are notoriously complicated, and CSUK is far from the first firm to fall afoul of them and be penalised as a consequence. The breaches were regarded as one level below the highest level of seriousness by the FCA, which also increased the penalty to reflect CSUK's failure to pay heed to the earlier penalties imposed on other firms. After the discount for early settlement, these breaches accounted for £7,138,000 of the total penalty.

The second component of the penalty reflected CSUK's breach of s20 FSMA by carrying on business for which it did not have permission, because its application to vary its permissions prior to the change in 2017 mistakenly failed to select permission to safeguard and administer assets without arranging (because arranging was outsourced to CS&C). CSUK identified this lacuna and made a further application to vary its permission to include arranging the safeguarding and administration of client assets without telling the FCA that it was already carrying out this activity without permission. That resulted in an additional penalty (after the discount) of £338,033, again on the basis that the seriousness of the breach was one level below the highest level of seriousness.

The most interesting aspect of the Final Notice relates to the last component of the penalty, the P11 breach.

The most interesting aspect of the Final Notice relates to the last component of the penalty, the P11 breach. In the course of considering CSUK's application to vary its permissions, the FCA sent CSUK various requests for information, including for confirmation that CSUK had *"written confirmation from your auditor that adequate systems and controls are in place to manage both client money and client asset transactions"*. CSUK's replied that its auditors had "confirmed we have adequate systems and controls in place to manage client money and client asset transactions". That statement was incorrect. Those responsible for reviewing and drafting CSUK's reply assumed that there was a written record of the auditor's confirmation and exchanged emails about locating it. But they failed to make appropriate enquiries and didn't realise that no such record existed. The FCA relied on CSUK's reply when it approved CSUK's application. Had CSUK failed to provide the confirmation, the FCA would have investigated the position further — and might have rejected the application, in light of the other issues.

The P11 breach surfaced because CSUK's auditors' initial client assets report recorded a number of breaches relating to CSUK's arrangements for holding and controlling client money and safeguarding assets (which were remediated subsequently). When CSUK notified the FCA under P11 of the auditors' likely conclusion, it declared that the report was the first time the auditors had considered CSUK's client asset systems and controls.

The Final Notice says:

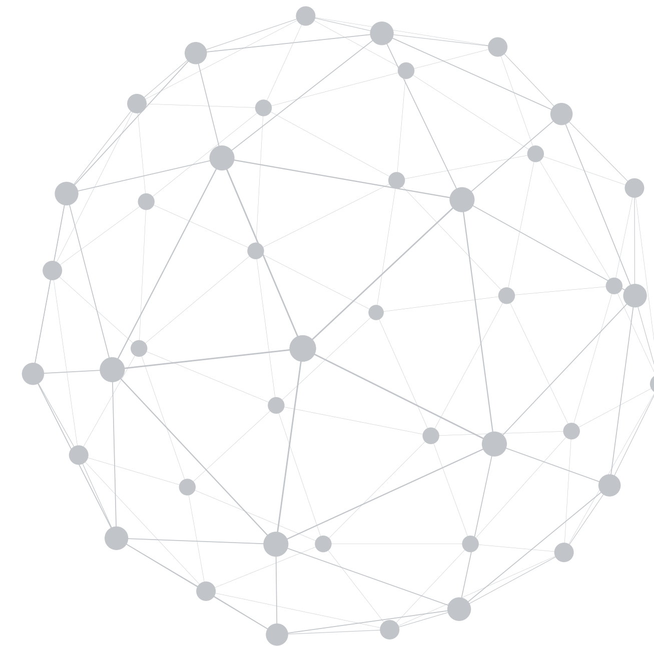
The Authority considers that Principle 11 does not apply only in cases where a firm chooses not to disclose information to the Authority. Principle 11 also applies where, in providing information to the Authority, a firm fails to ensure that all information it provides to the FCA is factually accurate. CSUK breached Principle 11 because it failed to take reasonable steps to ensure that the information it provided to the Authority was accurate. CSUK should have made enquiries from its auditors before making representations to the Authority. By failing to do so, CSUK took the risk that its response was not accurate. Consequently, the Authority considers that CSUK recklessly provided inaccurate information to the Authority and thus failed to meet its obligations under Principle 11.

The consequences for CSUK were serious. Like the breach of s20 FSMA, the FCA concluded that the breach of P11 was one level below the highest level of seriousness, which resulted in a penalty of £398,371. The FCA also concluded that this amount was an insufficient deterrent to CSUK and others — and so multiplied it by a factor of four, resulting in a penalty (after the discount) of £1,115,400 and a total penalty of £8,963,200.

In a sense, the Final Notice statement, above, seems obvious. But it's perhaps not as obvious as it sounds that a firm can breach an obligation to "deal with its regulators in an open and cooperative way, and ... disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice" negligently, or even recklessly. Breaching a rule or section of FSMA by doing something that is prohibited without the necessary permission or failing to do something that is required is fairly straightforward in most cases. Either the firm did — or failed to do — the thing concerned, and the only question is whether enforcement is appropriate and, if so, what is the appropriate penalty. CSUK did not set out to hide something from the FCA; it just did not ask itself all the right questions.

Be that as it may, CSUK accepted the FCA's conclusions, and the bar for potential liability for breaching P11 has been lowered as a consequence. Firms now must be able to demonstrate that, when they deal with the FCA, they have asked all the right questions — and tested the answers — or risk being found to have breached P11 as a result. But things sometimes go awry in even the best-run firms — and precisely where the boundary lies between a reckless breach of P11 and an honest mistake that is hopefully not a breach may be difficult to discern in future enforcement cases, particularly in the absence of sufficient information about how CSUK got itself into a muddle from which legal advisors can try to identify a bright (or even dimly glowing) line between the two.

TechTrends: The Woolard Review — A Review of Change and Innovation in the Unsecured Credit Market



FCA Report: The Woolard Review — A Review of Change and Innovation in the Unsecured Credit Market

The UK government has announced that interest-free buy-now-pay-later (BNPL) credit agreements will be regulated by the FCA. Currently, the BNPL market operates under an exemption from regulations for consumer credit lending.

The announcement comes as a review of the unsecured credit market, led by Christopher Woolard, unexpectedly urgently recommends regulating all BNPL products.

The Woolard Review (Review) sets out 26 recommendations for the FCA, UK government, and other bodies to reform the unsecured credit market. The recommendations take into account the impact of the COVID-19 pandemic, changing business models, and new developments in unregulated BNPL unsecured lending.

The UK government has announced that interest-free buy-now-pay-later (BNPL) credit agreements will be regulated by the FCA.

Buy now pay later

Unregulated BNPL products rely on an exemption found in Article 60F(2) of the Regulated Activities Order (RAO) for credit agreements that are interest- and fee-free, and are repayable within in a period of 12 months or less. As such, they currently fall outside the FCA's perimeter, and providers of credit are not required to be authorised by the FCA.

The Review recommends that the FCA urgently work with the Treasury to create legislation to ensure that all BNPL products are brought within the scope of regulation to better support a healthy unsecured lending market. Once the FCA has obtained the necessary powers, the FCA will need to develop a proportionate regulatory framework, including addressing how credit information should work within this market. The Review states that an exemption should still be available for agreements outside the BNPL market, including for "short-term invoice deferral" and for items such as gym memberships, dental payment plans, and sports club membership fees.

Once unregulated BNPL products are brought within the regulatory perimeter, lenders will need to be authorised and regulated by the FCA.

Once unregulated BNPL products are brought within the regulatory perimeter, lenders will need to be authorised and regulated by the FCA. Lenders will be subject to appropriate high-level regulation but also to a regime that is proportionate and caters to the wide variety and number of partner retailers, which will be required to become authorised credit brokers when they refer their customers to BNPL providers. The option of becoming an Appointed Representative for credit broking instead of becoming individually authorised could be an attractive option for some firms not wishing to obtain a licence and, which would still allow them to refer customers to BNPL lenders. Lenders will be required to carry out affordability checks on all customers before lending and to ensure that they treat consumers fairly, particularly those who are vulnerable or struggling with repayments. Firms will also have to comply with the financial promotions regime, and customers will be able to escalate any complaints to the Financial Ombudsman Service — a protection that customers do not currently have.

The UK government has stated that legislation will be brought forward as soon as parliamentary time allows. However, before this, the UK government still needs to launch a consultation on how the regulation should be implemented and to ensure that its approach is proportionate. It is, therefore, possible that it will be two or more years before there is any change in law. However, Woolard states in the Review that given the immediate passage of the Financial Services Bill through Parliament, he has already written to Treasury ministers about the matter, suggesting a possible imminent amendment to the Financial Services Bill and emphasising the urgency with which this matter is being dealt with.

Many questions remain unanswered. Will we see a similar transitional period, as was allowed for the transfer of regulation to the FCA, to allow lenders to run off their books if they choose not to seek authorisation? Will the additional authorisation costs, and continuing costs of compliance, force many lenders out of the market? Will this create opportunities for some of the larger firms to expand into the BNPL space? Only time will tell.

The BNPL space has attracted a large amount of investment in recent years, including in the private equity arena and in relation to the securitisation of consumer receivables. Given that regulation of these products was not previously on the horizon, investors will want to check that they have sufficient contractual protections to protect their positions and investments as BNPL providers consider their options.

Debt advice

According to the Review, the FCA must urgently coordinate with the UK government, devolved administrations, and insolvency regulators to ensure that suitable debt solutions are available to best serve people in financial difficulties. In particular, the FCA and the UK government must ensure that the imminent demand for debt solutions as a result of the COVID-19 pandemic is met. This response should include identifying quick actions to remove or reduce barriers to accessing suitable solutions (including fees) and steps to reduce the number of consumers being driven towards unsuitable solutions (including the role that marketing plays in this).

The Review emphasises that debt solutions must be suitable — meaning known problems in the personal insolvency sector need addressing — and fees for debt relief orders should not prevent people who are less well off from accessing the help they need.

Forbearance

The Review encourages the FCA, in conjunction with lenders and credit reference agencies (CRAs), to conduct a review of how forbearance is reflected in credit information and how this affects decisions made by lenders and consumers. This review should:

- Assess the potential impact of the approach taken to the "masking" of credit files
- Look at the current arrangements for reporting forbearance to CRAs and whether these are consistent and adequate
- Identify any areas where credit information could better reflect individual consumer circumstances and respond in a more nuanced way to changes in those circumstances (e.g, a "neutral" marker that indicates an individual needs help because of COVID-19 on a longer-term basis)

Other key recommendations

Other recommendations in the Review include:

- Providing more alternatives to high-cost credit
- Building a better credit information market, underpinning a sustainable credit market and better lending decisions
- Ensuring that regulation of the credit sector is more outcomes focused, looking at how products are used in the real world and consistently regulating on that basis
- Providing guidance for digital design in the consumer credit sector that focuses on good consumer outcomes, to ensure that consumers are informed and remain in control of their decision making
- Reviewing repeat lending

Next steps

The FCA has confirmed that it welcomes and supports the recommendations in the Review, recognising the urgency to regulate all BNPL products.

The FCA has already written to the Treasury setting out its views and proposing that the FCA work with the UK government to define the appropriate regulatory framework. In April 2021, the FCA will publish its 2021/22 Business Plan, which will further detail the FCA's response to the Review.

Global Insights: Hong Kong

SFC Updates FAQs on Compliance With Suitability Obligations and Requirements for Complex Products

On 23 December 2020, the Securities and Futures Commission of Hong Kong (SFC) published certain new frequently asked questions to the FAQs on Compliance With Suitability Obligations by Licensed or Registered Persons (FAQs on Compliance With Suitability Obligations) and the FAQs on Guidelines on Online Distribution and Advisory Platforms and Paragraph 5.5 of the Code of Conduct (FAQs on Complex Products).

By way of background, the FAQs on Compliance With Suitability Obligations and the FAQs on Complex Products provide guidance to intermediaries on the SFC's suitability assessment requirements when selling investment products.

FAQs on Compliance With Suitability Obligations

The FAQs on Compliance With Suitability Obligations provide further guidance on how intermediaries should devise their suitability assessment processes. In particular, the SFC clarified that:

- The suitability assessment process is not a mechanical risk matching process but a dynamic process that may vary depending on the client's circumstances. While the duty to ensure suitability remains the same, intermediaries may vary their processes and perform suitability assessments in a proportionate and risk-based manner.
- Concentration risk assessments should not be mechanical calculations. Exceeding a particular concentration level may be acceptable so long as the outcome is commensurate with the overall risk profile of the investment portfolio and the client's other circumstances.

The FAQs on Compliance With Suitability Obligations also provide further guidance on the discharge of an intermediary's obligation to explain the features and risks of investment products to clients. In particular, the SFC clarified that:

- A client may not necessarily be able to understand an investment product if the intermediary merely reads the product literature to the client. Intermediaries may vary their processes and provide product explanations in a proportionate and risk-based manner having regard to the circumstances. Instead of adopting a one-size-fits-all approach when explaining the features and risks of investment products to clients, intermediaries could tailor their product explanation processes according to the client's degree of sophistication.
- Intermediaries may also vary their disclosure processes for repeat transactions having regard to the above circumstances and the adequacy and timing of their previous disclosures.

FAQs on Complex Products

In relation to the product due diligence and disclosure of product information requirements under paragraph 5.5 of the Code of Conduct for Persons Licensed by or Registered with the SFC (the SFC Code of Conduct), the SFC clarified in the FAQs on Complex Products that, among other things:

- If asked by a client to purchase a product that is not on the firm's approved product list, the intermediary should perform due diligence based on all the information it obtains on a best-effort basis (including product offering documents, documentation provided by the issuer, and other information available in the public domain or from data providers).
- While intermediaries are not expected to form a "house" view of these complex products or perform ongoing product due diligence for complex products only made available to clients on an unsolicited basis, they should develop their policies on when the produce due diligence needs to be re-performed or updated if the clients subsequently request to purchase the same complex products.
- An intermediary may vary its processes and explain the complex product or make disclosures to the client in a proportionate and risk-based manner depending on the circumstances of each case (e.g., the level of disclosure may be different if a client is very familiar with the product).

HKMA Publishes FAQs on Investor Protection Measures

On 23 December 2020, the Hong Kong Monetary Authority (HKMA) published a circular providing guidance on investor protection measures in the form of FAQs.

By way of background, the HKMA first issued a circular titled "Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products" in September 2019 (the HKMA 2019 Circular) that provided guidance to authorised institutions (AIs) on their selling process for investment, insurance, and mandatory provident fund products. The HKMA has now provided further guidance in light of market developments, enquiries received, and recent communications with the banking industry.

Guidance provided by the FAQs include the following key aspects:

In dealing with large and/or sophisticated corporate customers, authorised institutions are exempted from adopting the investor protection measures set out in the HKMA 2019 Circular, except for the requirements on the assessment of customers' concentration risk (if suitability obligations are triggered), controls over transactions with mismatch(es) or exception(s), and product-specific guidance.

For a face-to-face sales process:

- Audio recording is not required for solicitation or recommendation of non-complex investment products, exchange-traded derivatives, and standardised structured deposits not regulated by the Securities and Futures Ordinance involving mismatch(es) or exception(s), other than risk mismatch.
- Audio recording is required for transactions of complex products that are for hedging purpose, unless the opt-out arrangement for audio recording applies.

For a non-face-to-face sales process:

- If the communication facility of an AI does not have record-keeping capability that allows the AI to record, retrieve, and monitor communication with customers, the AI is reminded to put in place compensating measures and controls to ensure compliance with relevant regulatory requirements.
- In particular, if the relevant communications are conducted through video-conference, AIs should audio-record the relevant conversations with customers or the relevant recap for investment transactions conducted through video-conference (regardless of whether solicitations or recommendations are involved and whether complex products are involved). The recording should cover (where applicable) suitability assessment, product disclosure, and order placement and confirmation, and should be retained according to applicable requirements.

For customers that are not retail banking customers, AIs may streamline the product disclosure requirement (regardless of whether it is a first transaction or a subsequent transaction of comparable products), provided that the AI assures itself that the customer understands the investment product before entering into a transaction. AIs should maintain a record (either written or audio) to evidence that the customer understands the product and does not require a full product disclosure in the circumstances.

AIs should ensure that the methodology and threshold(s) for assessing the concentration risk of customers and determining a customer's financial assets and investment holdings to be used in the concentration risk assessment are reasonable. In particular:

- There may be different ways to assess the concentration risk, one of which is to focus on the risk level of the products and the customer's circumstances.
- In general, it would be reasonable that the same basis is adopted for both the denominator (i.e., the customer's financial assets) and the numerator (i.e., the customer's holdings in the product on a cumulative basis) when assessing the concentration risk of a customer.
- AIs may accept a customer's declaration on the amount, details of the customer's financial assets, and investment holdings outside of the AI for the purpose of assessing concentration risk.
- For leveraged transactions, unless otherwise specified by the HKMA, AIs should use the maximum exposure (not merely the margin required) of the leveraged transactions in assessing the concentration risk.

AIs may distribute, solicit, or recommend investment products to a customer as long as it fulfils the suitability obligations where applicable (such as for complex products or transactions involving solicitation or recommendation) even if the transaction may involve mismatch(es) or exception(s). For example, if a customer has a low- or medium-risk profile, a proportion of high-risk products may not be unsuitable so long as this is commensurate with the risk return profile of the portfolio and the AI is able to satisfy itself that any investment products recommended are likely to meet the investment objectives and other personal circumstances of the customer. AIs are reminded to take additional control steps set out in the HKMA 2019 Circular and document the reason for the transaction.

Further guidance on the sale of investment products to vulnerable customers and the sale of insurance products and MPF products are also set out in the FAQs.

The HKMA reminded AIs that the SFC issued a circular on 23 December 2020 titled "Frequently Asked Questions on Compliance With Suitability Obligations and Requirements for Complex Products".

What to Look Out for in Q2 2021

- FCA consultation expected on the RTS 27 reporting obligation
- BEIS consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs closes
- Breathing Space Regulations to enter into force
- UK government to publish detailed second consultation paper on the second phase of the Financial Services Future Regulatory Framework Review

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