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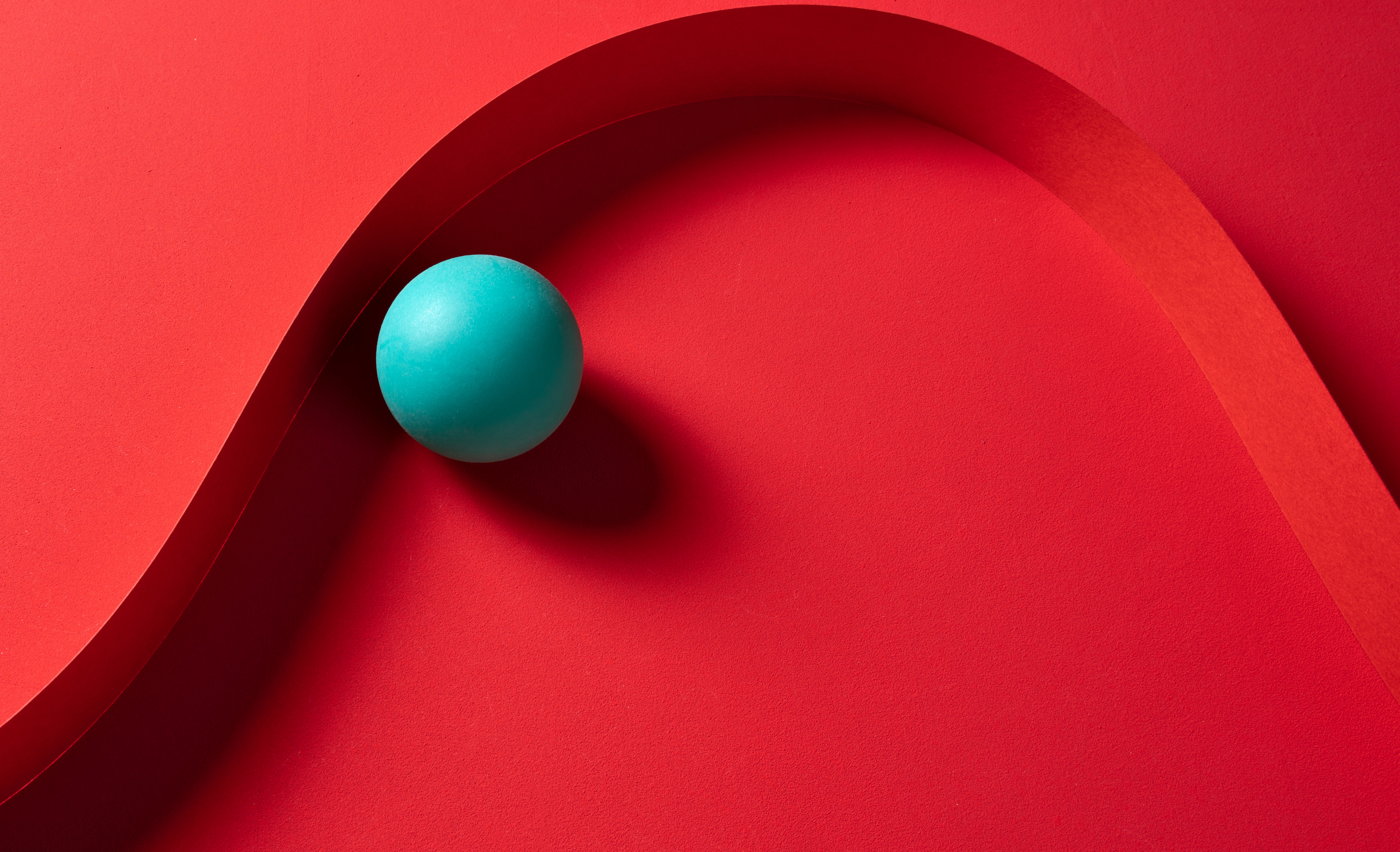
Financial Regulation Legal Outlook 2023



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Financial Regulation
Legal Outlook 2023

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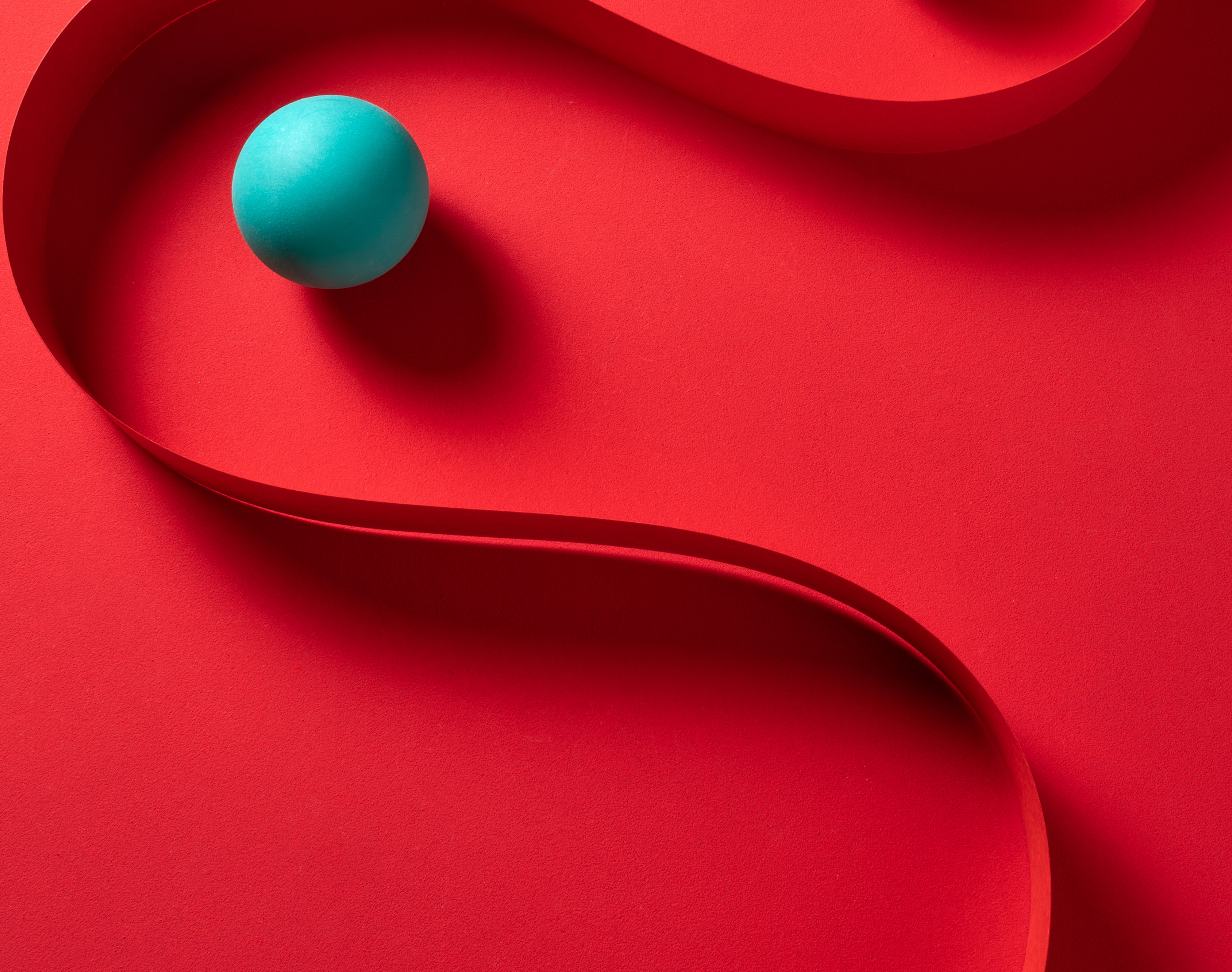


Banking

What's coming up in Financial Regulation: key events and publications for 2023

UK

EARLY/Q1 2023

Wholesale Markets
Early 2023 - FCA expects to publish policy statements on changes to equity transparency requirements and trading venue perimeter

Wholesale Markets
Q1 2023 - FCA expected to publish policy statement and consultation on EMIR REFIT level 3 documentation

Prudential
2023 - First disclosures under IFPR will be due

Future UK Regulatory
2023 - UK regulators expect to consult on operational resilience critical third parties to the UK financial sector and on operational incident reporting requirements

FEBRUARY

Consumers
1 Feb - All other new FCA rules on strengthening financial promotion requirements for high-risk investments start to apply

Consumers
28 Feb - Deadline for principal firms to submit s165 appointed representatives request to the FCA

MARCH

Wholesale Markets
End of Mar - Cessation of 1- and 6-month synthetic sterling LIBOR

Q2 2023

Wholesale Markets
H1 2023 - FCA to consult on equity and non-equity transparency regimes and on what a consolidated tape might look like in the UK

ESG
H1 2023 - The FCA's ESG Data and Rating Code of Conduct Working Group is expected to publish first draft of the Code of Conduct for consultation

Consumers
Spring 2023 - CMA to provide an update on its ongoing investigation into alleged anti-competitive arrangements in the financial services sector

Future UK Regulatory
Spring - Financial Services and Markets Bill 2022-23 (FSMB) expected to be enacted

April

Consumers
Apr - FCA expects to deliver its consumer investment strategy and final rules on its new streamlined investment advice regime

Financial Crime
1 Apr - The MLR requirement on reporting material discrepancies takes effect

Wholesale Markets
24 Apr - Contracts referencing USD LIBOR will be removed from the scope of the clearing obligation (which is when CCPs will contractually convert outstanding USD LIBOR contracts)

Consumers
30 Apr - Manufacturers should aim to complete all the reviews necessary to meet the four outcome rules under the Consumer Duty for their existing open products and services

JUNE

Wholesale Markets
30 Jun - US dollar LIBOR settings cease

Wholesale Markets
18 Jun - UK EMIR clearing obligation exemption for pension scheme arrangements due to expire (unless extended)

ESG
30 Jun - FCA expected to publish final rules on Sustainability Disclosure requirements and investment labels. FCA proposes its general anti greenwashing rule comes into force

JULY

Consumers
31 Jul - Consumer Duty rules start for new and existing products or services that are open to sale or renewal

AUGUST

Consumers
From Aug - In scope firms need to start to complete review of closed products before Consumer Duty comes into force for closed products in July 2024

Consumers
31 Aug - Pension providers to implement pension dashboard rules

SEPTEMBER

Financial Crime
1 Sep - UK version of FATF's travel rule starts to apply

Q3-4 2023

ESG
Q3 - Government to consult on TSC relating to sustainable use, pollution prevention, the circular economy and biodiversity under the UK Green Taxonomy

NOVEMBER

Consumers
30 Nov - Firms first annual reviews of Appointed Representatives assessments due

DECEMBER

Future UK Regulatory
End of 2023 - Close of UK's temporary permissions regime

Consumers
8 Dec - Deadline for principals to have carried out their first annual review of Appointed Representatives

EARLY/Q1 2023 | JANUARY | FEBRUARY | MARCH | Q2 2023 | April | MAY | JUNE | JULY | AUGUST | SEPTEMBER | Q3-4 2023 | OCTOBER | NOVEMBER | DECEMBER

EU

EARLY/Q1 2023

Wholesale Markets
Q1 2023 - ESMA expects to publish final report on MiFID II product governance guidelines

Wholesale Markets
Q1 - ESMA to publish final guidance in the form on an opinion on market outages and its final opinion on the trading venue perimeter

Consumers
Early 2023 - Commission expected to adopt its strategy for retail investors

Financial Crime
2023 - ESMA will assess the need for new guidance on the disclosure of inside information in relation to the resolution regime

Prudential / ESG
During 2023 - First ESG disclosures under IFR will be due

JANUARY

Wholesale Markets
1 Jan - Article 3(1) of the CSDR will apply to transferable securities issued after 1 January 2023

ESG
1 Jan - Disclosure requirements in the Taxonomy Regulation relating to remaining environmental objectives start to apply

ESG
1 Jan - Delayed date of application of SFDR RTS

ESG
1 Jan - Complementary Climate Delegated Act covering gas and nuclear activities start to apply

Wholesale Markets
Early Jan - European Parliament is expected to finalise report on its General Approach under the CSDR review

FEBRUARY

Wholesale Markets
Jan/Feb - European Parliament expected to adopt final report on amendments to EU MiFID II Review

Fintech
13-16 Feb - European Parliament to consider proposed MiCA and transfers of funds and certain cryptoassets

MARCH

ESG
By Mar - Banks are expected to adequately categorise climate and environmental risks and conduct a full assessment of their impact on banks' activities

ESG
Mar - TNFD aims to publish final draft version of its disclosure framework

Wholesale Markets
Mar - ESMA's guidelines on MiFID II suitability requirements are expected to apply

Q2 2023

Wholesale Markets
Q2 - Trilogues are expected to commence on EU MiFID review

ESG
Q2/Q3 - ESMA expects to publish final guidelines on funds' names using ESG or sustainability-related terms

Financial Crime
Q2 - EBA expects to issue guidelines on de-risking

MAY

ESG
17 May - ESAs due to provide progress reports to Commission on greenwashing risks and supervision of sustainable finance

JUNE

ESG
30 Jun - Financial market participants due to make first principal adverse impacts (PAI) statement under SFDR RTS

Wholesale Markets
30 Jun - Publication of USD LIBOR ICE Swap Rate will cease

SEPTEMBER

ESG
Sep - Task Force on Nature-related Financial Disclosures (TNFD) expects to publish final version of its disclosure framework

Q3-4 2023

Wholesale Markets
Q3 - Political agreement is expected to be reached on EU MiFID Review

ESG
Q3 - ESAs expected to respond to Commission with amendments to SFDR RTS relating to PAI indicators (original deadline of 28 April is delayed by six months)

Financial Crime
Q4 - EBA to issue revised guidelines on ML/TF risk factors, transfers of funds and on risk-based supervision

NOVEMBER

ESG
Nov - ESAs due to report to Commission on amending the SFDR RTS to reflect PAI indicators and enhanced transparency

DECEMBER

ESG
29 Dec - EBA to deliver its advice to the Commission on green loans and mortgages

ESG
31 Dec - Commission expected to publish an assessment of impact of EU sustainable finance agenda

ESG
By end of 2023 - Banks must manage C&E risks with an institution-wide approach covering business strategy, governance and risk appetite, as well as risk management, including credit, operational, market and liquidity risk management.

Wholesale Markets
End of 2023 - ESMA expects to publish report on rules for passporting for investment firms

Click to read more

Consumers | Wholesale Markets | ESG | Financial Crime | Future UK Regulatory | Prudential | Fintech

Wholesale Markets Reform overview – UK and EU

The area of wholesale financial markets regulation has been the front-runner for EU and UK divergence.

Certain changes to the UK MiFID regime are already being implemented, with others subject to consultation and on track to be delivered in the near to medium term. 2023 will bring confirmation of the depth of divergence of the EU/UK MiFID regimes, as EU legislators decide to what extent they will follow some of the UK changes, as they finalise Level 1 changes to MiFID II and MiFIR and move on to the detailed requirements in technical standards.

ESG enhancements to EU MiFID suitability and governance requirements have been applied in the course of 2022, and these will bed down during 2023, with market practice likely to evolve in the medium term as demand for "green" products increases and related ESG data becomes more readily available.

There was good news in 2022 with the suspension of the EU CSDR mandatory buy-in regime. Although there is now uncertainty as to where the Commission will end up on this, there is support from the European institutions to remove this regime from CSDR altogether. This will be one to track in 2023.

Proposed amendments to EMIR (known as the Clearing Proposal) have just been published – these address clearing thresholds and distinguish between cleared and uncleared transactions – but are unlikely to be in force in 2023.

These topics and themes are explored in greater detail in the following pages.

MiFID II

EU MiFID Review & UK Wholesale Markets Review

Although 2022 started with the EU MiFID Review "in the lead" (Commission legislative proposals having been published in November 2021), the UK quickly "overtook" the EU with changes to UK wholesale markets regulation. In turn, some of the immediate and upcoming UK changes have informed the EU MIFID Review, as EU policymakers consider whether some of the UK changes could have adverse competitive impacts for EU markets, unless they are replicated in the EU regime.

Overall, the themes of the reforms in the UK and EU are similar and include seeking to re-calibrate the equity and non-equity pre- and post-trade transparency regimes (ie waivers, thresholds, deferrals), addressing the quality of, and access to, market data (including through the creation of a consolidated tape provider per asset class), revisiting guidance on the trading venue perimeter and ensuring that investor protection measures (including disclosures) are not overly burdensome.

Where are we in the UK, and what's to come in 2023?

In the UK, HM Treasury has been able to quickly take forward bolder regulatory changes (such as the removal of the UK share trading obligation and double volume cap), some of which were already included in the Financial Services and Markets Bill (and suspended until this legislation is finalised, with relevant transitional powers of the FCA extended until the end of 2024). The Bill also provides, amongst other things, for SIs to be allowed to execute client orders at mid-point within the best bid and offer for all trades, and for the SI definition to become purely qualitative (thereby removing the onerous SI calculations). In addition, the Bill empowers the FCA to recalibrate the non-equities transparency regime, to put in place a regime for consolidated tape providers, to simplify the position limits regime, to describe post-trade risk reduction services which will be exempt from the UK derivatives trading obligation (DTO), and to suspend and modify the UK DTO. The Bill also envisages for the whole UK MiFID regime to be rewritten (in the medium to longer term) into the FCA Handbook and put under FCA powers (as further described in our section on the Future UK Regulatory Framework).

This means that the UK MiFID regime should be more "flexible" to amend in response to market developments or concerns. In fact, the FCA has already set up a secondary markets advisory panel to support upcoming regulatory changes to the UK transparency regimes.

In H2 2022, the FCA started to consult on changes to equity transparency requirements and the creation of a new designated reporter regime for (equity and non-equity) post-trade reporting, and on the trading venue perimeter. We expect policy statements on these by the end of 2022 or in early 2023.

We also expect, around the end of 2022, an FCA report on the FCA's 2022 review of the cost, pricing and licensing terms for accessing wholesale market data.

In the first half of 2023, the FCA will publish a further consultation on transparency (or possibly two consultation papers covering equity and non-equity transparency separately). The FCA will also consult on what a consolidated tape might look like in the UK.

Where are we in the EU, and what's to come in 2023?

In the EU, both the Council of the EU and the European Parliament have been working on their respective amendments to the Commission proposals. The EU institutions have been following UK wholesale markets reforms and the Commission has indicated that it considers that many of the changes to the UK regime which are flagged above could have adverse competitive impacts for EU markets, unless replicated.

We have seen several of the UK reforms picked up and replicated (even if not identically) in proposed changes to the EU Level 1 texts. For example, the European Parliament proposes a 5-year suspension of the EU double volume cap), and both legislators suggest giving ESMA more flexibility in calibrating the non-equity transparency regime (even though we have yet to see how much detail may be hard-wired into Level 1). The EU legislators have also: proposed a regime similar to the new UK designated reporter regime for post-trade reporting (which decouples reporting obligations from SI status); suggested reverting to a qualitative SI definition to eliminate the onerous SI calculations; proposed to remove SI non-equity pre-trade transparency requirements; and suggested exemptions for post-trade risk reduction services from several obligations. The Council's latest compromise text also envisages allowing SIs to match orders (of any size) at mid-point within current bid and offer prices (as in the UK).

Further resources

- **Read:** Our note on the Commission legislative proposals for the EU MiFID Review (November 2021)
- **Read:** Our note on HM Treasury consultation response to the UK Wholesale Markets Review (March 2022)
- **Read:** Our note on the Financial Services and Markets Bill (July 2022)
- **Read:** Our note on the latest European Parliament and Council positions on the EU MiFID Review (November 2022), although refinements to the positions summarised here are continuing to emerge as we approach further Council meetings during December 2022

At the time of writing, the Council and European Parliament appear to be resolving some key outstanding issues. In particular, both legislators appear to be willing to continue to allow payment for order flow (PFOF), even if the detailed conditions for allowing it (and any measures to track the impact of PFOF on best execution, and the role of CTP data including EBBO) will need to be negotiated. On CTPs, both legislators appear to agree that a bonds CTP should be prioritised, followed by the CTP for shares/ETFs (but, whilst the Council is proposing to delay the derivatives CTP until issues around derivatives identifiers have been resolved, the Parliament suggests that a further cost/benefit analysis is needed before agreeing to a derivatives CTP at all). Both legislators' current proposals also make reference to best bid and offer data being captured by the CTP, which in turn may support any conditions imposed on PFOF.

However, there is still a lot to be discussed on other topics, including non-equity post-trade deferrals, where Council and Parliament proposals differ, including on the length of the all-important deferral periods. Both legislators' positions are still subject to change. In addition, some important aspects (such as commodity derivatives topics) are yet to follow.

In terms of timing, at the time of writing:

> The Council is still working towards a compromise position by end of 2022 (although Q1 2023 is looking increasingly more likely, at the time of writing)

> The European Parliament hopes to publish its final report in January / February 2023

> Trilogues are expected to commence in Q2 2023 and to conclude in a final political agreement in Q3 2023

> Publication in the Official Journal and entry into force could then happen in Q3 / Q4 2023

> Amendments to MiFIR are proposed to apply 21 days after publication in the OJ

> Amendments to MiFID II will need to be implemented by Member States within 12 months

> The proposals envisage several delegated acts and changes to existing technical standards, as well as the creation of new RTS (eg to facilitate the creation of CTPs and related data standards). Consultations on these will follow once the legislative position on the Level 1 text is settled.

As part of the EU MiFID Review process, ESMA had published numerous review reports to the Commission with proposals to change Level 1 and Level 2 technical standards. In 2023 (and beyond), we can expect ESMA to consult on some of the RTS/ITS changes (eg on transaction reporting, algorithmic trading and equity / non-equity transparency), taking account of the final Level 1 text.

This will include changes to RTS 1 and 2, which ESMA had already started to amend in a "phased" process, phase 1 of which has been delayed throughout 2022, with the Commission reportedly suggesting certain changes to be made to ESMA's RTS 1 / 2 changes.

ESMA's final opinion on the trading venue perimeter is expected to be issued by the end of 2022 or in Q1 2023. Most recent indications are that ESMA's stance from the consultation (which included suggestions that execution and order management systems could be in scope of the trading venue perimeter) may be "softening".

ESG enhancements to EU MiFID

Since August 2022, EU investment managers and financial advisers have been required to obtain and incorporate their clients' "sustainability preferences" in the suitability assessment they undertake when making investment decisions / personal recommendations. ESMA only finalised its updated suitability guidelines, taking account of these ESG enhancements, in September 2022. Also since August, firms must account for sustainability risks in risk management and organisational rules, and any conflicts with client sustainability preferences must be identified and managed.

From 22 November, manufacturers and distributors subject to EU MiFID II must specify, as part of their target market assessments, any sustainability related objectives the relevant product is compatible with. ESMA has consulted on changes to its product governance guidelines to incorporate these ESG enhancements (alongside observations following a common supervisory action). The final guidelines are expected in Q1 2023, so (as with the ESG enhancements to the suitability assessments) firms are currently "in limbo" and have had to take a view on whether to implement in line with the draft guidelines.

Market practice will continue to evolve in 2023, and as more ESG data becomes available that may make the marketing of financial products as "green" easier for manufacturers and distributors, or as demand for "green" products increases.

There have been no ESG-related enhancements to the UK suitability or product governance rules yet. HM Treasury and the FCA have, rather, been monitoring the developments of global ESG standards (and perhaps the development of ESG data which could better support firms in their suitability and product governance related obligations) and plan to make ESG enhancements to the UK regime in due course. Timing for any UK enhancements is yet to be confirmed.

Further resources

Read: Our note on the FCA's CP on equity transparency requirements and designated reporter regime for post-trade reporting (July 2022)

Read: Our note on ESMA's CP on the trading venue perimeter (January 2022)

Read: Our note on the FCA's CP on the trading venue perimeter (September 2022)

Read: Our blog post on ESMA's final updated suitability guidelines (September 2022)

Read: Our note on ESMA's CP on the product governance guidelines (July 2022)

CSDR

The CSDR's Settlement Discipline regime has continued to be beset with complications in 2022, although there is now hope that the industry's preferred outcome of no regulatory mandatory buy-in may be in sight.

After significant delay, the Regulatory Technical Standards on Settlement Discipline (Commission Delegated Regulation (EU) 2018/1229) finally entered into force on 1 February 2022. These RTS included the mandatory buy-in provisions and the cash-penalties framework.

Mandatory buy-ins

However, the European authorities had already agreed to amend CSDR to suspend the application of the mandatory buy-in rules (with the cash penalties provisions and settlement fails reporting provisions continuing to apply). This was based on lack of clarity on some critical open questions necessary for implementation of the buy-in requirements and uncertainty around the scope of the forthcoming CSDR Refit (in particular whether it would include amendments to the mandatory buy-in regime and the extent of any such amendments). Pending such amendment coming into force, ESMA issued a statement to NCAs proposing regulatory forbearance as regards compliance with the mandatory buy-in rules.

A Delegated Regulation suspending the application date of the mandatory buy-in regime until 2 November 2025 has now come into force.

We now await the outcome of the CSDR Refit to determine what form and scope, if any, a mandatory buy-in regime will take, although note that the ECB has advised that the entire application of the mandatory buy-in regime should be removed (see further below).

Cash penalties

The cash penalties regime has been in operation since 1 February 2022, despite the suspension of the rules on mandatory buy-in.

Since then, ESMA has consulted on changes to the cash penalties framework, specifically Article 19 of the Settlement Discipline RTS, and in November, ESMA published its final report with proposed draft RTS. The current Article 19 provides for a specific collection and distribution process for cash penalties to be carried out by central counterparties (CCPs). The proposed amendment would remove the CCP-run separate process and would put the CSDs in charge of the entire process of collecting and distributing penalties according to Articles 16, 17 and 18 of the same regulation, establishing a single harmonised process for all transactions (both cleared and uncleared).

In its response to the consultation, the FIA commented that it: *"supports ESMA's proposals to remove the process of collection and distribution of penalties by central counterparties for cleared transactions. This will allow for the centralisation of the collection and distribution process of cash penalties for both cleared and uncleared transactions upon a single entity (central securities depository), allowing for a more straightforward and consistent approach, centred on the settlement step regardless of trading flow. Removing CCPs from the cash penalty process will reduce risk and improve the operating environment. FIA recommends that the amendment is introduced without additional delays, as the burden imposed by a bifurcated regime is ultimately detrimental to the smooth running of the CSDR cash penalty regime and the EEA's capital markets."*

Further resources

Read: Our client note on the Commission's CSDR Refit proposal

ESMA's draft has now gone to the European Commission for adoption in the form of a Commission Delegated Regulation. Following adoption by the Commission, the Commission Delegated Regulation will be subject to the non-objection of the European Parliament and of the Council. It should come into force during 2023.

CSDR Review

Now that most of CSDR has been in force for some years, the Commission has carried out a review of how it is operating. In March, the Commission published a legislative proposal for a regulation amending the CSDR (known as the CSDR Refit proposal). The proposed amendments impact a range of areas covered by the legislation. In respect of the settlement discipline provisions, the proposal is to retain the mandatory buy-in regime so that it can be introduced if levels of settlement failures are not reduced by the other settlement discipline provisions but enable its application to be limited in various ways, for example as regards types of transactions in-scope.

In August, the ECB issued an opinion (published in the Official Journal on 26 September 2022) welcoming the Commission proposal but making several suggestions. Among other things, the ECB advised that the entire application of the mandatory buy-in regime should be removed, stating that it would cause *'a significant interference in the execution of securities transactions and the functioning of securities markets'*. It also highlighted the *'non-availability of a buy-in agent'* in the market. In addition, if the Commission decides to retain mandatory buy-in, the ECB invites the Commission to consider excluding securities financing transactions entirely from its scope.

In October, the Parliament's Economic and Monetary Affairs Committee published a draft report on the Commission's CSDR Refit proposal in which it supported the ECB proposal. Its suggestion is to discard the regime completely and instead reintroduce into the Short Selling Regulation the central counterparty buy-in provisions against naked short-selling that already existed before the CSDR was implemented.

The Council is now working on its "General Approach". Word is that this is proceeding slowly on all points under discussion, with agreement slow to be reached with each Member State. We expect to see the General Approach by the end of 2022/early January 2023. Concurrently, Parliament is working on its compromise text. A report is expected in Q1 2023, after which trilogues (to negotiate the finalised regulation) can commence.

UK developments

The CSDR settlement discipline regime was not onshored as part of Brexit, and the UK is not proposing to introduce its own regulatory settlement discipline regime, although many UK asset managers are, nonetheless, indirectly impacted by the EU regime, as their EU brokers and custodians seek to pass on (contractually) many of their obligations, especially in relation to cash penalties.

The rest of CSDR (ie all other aspects than those relating to settlement discipline) was onshored. Part 1 of the Financial Service and Markets Bill contains a mechanism that allows for the revocation of the bulk of financial services retained EU law, which will include the UK CSDR, with such retained law being replaced by new UK legislation or regulatory rules. The government has not given a formal deadline for this, however in the explanatory notes to the Bill, HM Treasury states that the process will take a number of years.

The Bill introduces a general rule-making power for the Bank of England over CSDs to enable it to undertake primary responsibility for setting regulatory requirements for these entities. The Bill also provides the Bank of England with a power to impose requirements on individual CSDs.

Further resources

Read: Our client note on the Commission's CSDR Refit proposal

EMIR

We expect to see continued evolution of EMIR and UK EMIR in 2023, with developments across clearing, margin for uncleared derivatives and reporting of derivatives.

EU developments

Clearing

The Commission has conducted a targeted review of the central clearing framework in the EU, aimed at improving the competitiveness of EU CCPs, building clearing capacity in the EU and strengthening the EU's supervisory framework for CCPs. Following this review, the Commission's Proposal for a regulation amending EMIR ("Clearing Proposal") was published on 7 December 2022 and, as mentioned below, includes some significant changes, not limited to CCPs and EU clearing members. It remains to be seen how long it will take for the Clearing Proposal to be agreed with the Council and European Parliament and to come into force – this may well not be in the course of 2023. Furthermore, various provisions require technical standards to be made by ESMA and/or include a phase-in period.

The Clearing Proposal includes an amendment to the way in which the clearing thresholds are calculated under EMIR, to distinguish between cleared vs. non-cleared transactions rather than between exchange traded derivatives (ETDs) and OTC derivatives, which is helpful for EU entities that enter into derivatives transactions on UK venues, that are currently treated as OTC and therefore inscope of the clearing threshold calculations.

EU entities that are subject to the clearing obligation under EMIR will be required to maintain an active account with an EU CCP for clearing of certain transactions (denominated in euro and other EU currencies) within the scope of the clearing obligation. EU clearing members and clients will also need to report annually to their competent authority as to the extent to which they clear through recognised third country CCPs.

The energy crisis has also driven developments relating to clearing, and amendments to increase the clearing threshold for commodity derivatives from €3bn to €4bn, and temporary expansion of the pool of collateral considered eligible for energy derivatives by CCPs, subject to certain strict conditions, came into force on 29 November 2022. The Clearing Proposal includes a permanent amendment to permit EU CCPs generally to treat bank guarantees and public guarantees as highly liquid collateral, though subject to conditions to be set by ESMA.

The exemption from clearing for EEA pension schemes is set to expire on 18 June 2023 and there is no scope under EMIR for further extension of this exemption. Both ESMA and the Commission have called for pension schemes subject to the clearing obligation to be prepared to clear in-scope transactions from 19 June 2023. On the other hand, the Clearing Proposal includes an amendment to EMIR to permit EU FCs and NFC+s to transact with third country pension scheme arrangements that are not subject to a clearing obligation under their national laws, without the EMIR clearing obligation applying.

Further changes to the scope of the clearing obligation in light of ongoing progress on interest rate reform are expected, and in particular extension of the clearing obligation to certain TONA products, and a wider range of SOFR products, reflecting increasing liquidity in such products.

ESMA has recently announced that it will withdraw recognition decisions for six CCPs established in India previously recognised under EMIR.
The application of these decisions is deferred to 30 April 2023. Counterparties relying on ESMA

Further resources

Read: EMIR – new reporting requirements published in the Official Journal recognition to clear through any of these CCPs will need to follow these developments closely and respond accordingly.

Intragroup exemptions from clearing and margining

The transitional exemptions from clearing and margining for intragroup transactions with counterparties in non-equivalent jurisdictions are in the process of being extended to 30 June 2025. Regulatory forbearance is in place pending entry into force of these extensions. The Clearing Proposal sets out amendments to repeal the current "equivalence" provisions in Article 13 of EMIR, and to permit transactions with third-country affiliates to be treated as intragroup transactions within the scope of the exemptions, unless the third country concerned is classified as high risk or non-cooperative with respect to money laundering, terrorist financing or tax evasion, or otherwise identified as a country that may not benefit from these exemptions by the Commission by way of delegated act.

Margin for uncleared derivatives

With initial margin now fully phased-in following completion of Phase 6 in September 2022, potential in-scope counterparties will need to conduct the annual AANA calculation process on an ongoing basis. The EBA had consulted on RTS on initial margin model validation, and was expected to publish a final report and draft RTS in Q1 2023. However, amendments in the Clearing Proposal remove the mandate for these RTS suggesting that it is unlikely that these RTS will be made after all.

The temporary derogation from margin for single stock equity options and index options expires in early January 2024. Industry advocacy seeking continued exemption is underway. Counterparties relying on this exemption should monitor developments and make preparations for compliance with regulatory margining as necessary.

Reporting

As mandated as part of EMIR REFIT, new technical standards on the reporting requirements and procedures for data quality under EMIR were published in the Official Journal in October 2022. Reports will need to be made in accordance with the new standards, following an 18-month implementation period, from 29 April 2024.

With the level of detail to be reported significantly extended, including 89 new reporting fields, and a total number of 203 reporting fields, the implementation period will provide valuable time for counterparties to make necessary changes to processes and documentation.

Another point to note on reporting under EMIR is that the Clearing Proposal includes amendments to remove the current exemption from reporting that can be applied for with respect to intragroup transactions involving an NFC.

Looking further ahead

The next EMIR Review was expected to be carried out over the next year or so, with the Commission due to assess the application of EMIR by 18 June 2024. However, some issues anticipated to be addressed in the EMIR Review have instead been covered in the Clearing Proposal, and the Clearing Proposal provides for the next EMIR Review to be deferred to 5 years from the Clearing Proposal amendments coming into force. This means a delay for changes that might usefully be made to EMIR but are not included in the Clearing Proposal, such as an exemption from the clearing obligation for post-trade risk reduction (PTRR) exercises.

UK developments

Clearing

Under UK EMIR, the exemption from clearing for UK and EEA pension schemes similarly expires on 18 June 2023, unless extended by the Treasury. Any pension scheme subject to the clearing obligation will need to ensure that it has arrangements in place to clear in-scope derivatives ahead of that date.

The Bank of England's policy on tiering and comparable compliance of third-country CCPs was implemented on 1 December 2022. The Treasury has also announced that it intends to extend the Temporary Recognition Regime for third-country CCPs by a further 12 months to 31 December 2024. Those relying on this temporary regime should, however, be mindful that a number of CCPs do not wish to seek recognition in the UK and have entered into the run-off period which will end on 1 July 2023. The derecognition decisions made by ESMA outlined above may also impact continued reliance on the regime post end-April 2023 in respect of affected Indian CCPs.

In the UK, interest rate products relating to SOFR and TONA are already in scope of the clearing obligation. The Bank of England has issued a Policy Statement indicating that contracts referencing USD LIBOR will be removed from the scope of the clearing obligation on 24 April 2023 (which is when CCPs will contractually convert outstanding USD LIBOR contracts).

There are no proposals in the UK to increase the clearing threshold for commodity derivatives as being introduced in the EU.

Intragroup exemptions from clearing and margining

The transitional exemptions from clearing and margining for intragroup transactions with counterparties in non-equivalent jurisdictions under UK EMIR will expire, unless extended by the Treasury, on 31 December 2023. Industry advocacy is expected on this point, particularly in light of the amendments to the EU intragroup regime set out in the Clearing Proposal.

Margin for uncleared derivatives

The PRA and FCA jointly consulted earlier this year on amendments to the UK EMIR margin rules, including amending the scope of eligible collateral to include any third-country funds, not just EEA UCITS, but subject to strict conditions and introducing a six-month period implementation period for counterparties first coming in scope of margin requirements. It is hoped that these proposals will be implemented prior to the end of the year, when the temporary transitional provisions allowing EEA UCITS to be treated as eligible collateral for the purpose of the UK EMIR margin rules fall away.

As in the case of EMIR, following the completion of Phase 6, counter-parties potentially in-scope for initial margin will need to conduct the annual AANA calculation process on an ongoing basis.

It is also the case that the temporary derogation for single stock equity options and index options under UK EMIR will expire from early January 2024, unless extended. As in the EU, affected counterparties should monitor developments and prepare for regulatory margin compliance for these products as necessary.

Reporting

The FCA and Bank of England have jointly consulted on changes to reporting requirements, procedures for data quality, and registration of trade repositories under UK EMIR. The great majority of these proposals were aligned with the EU EMIR reporting rules noted above. However, the UK proposals have not yet been finalised. As in the EU, it was proposed that there would be an 18-month implementation period before the new standards took effect. It therefore appears likely that the UK changes will take effect after the 29 April 2024 implementation date in the EU, though it remains to be seen whether the UK will align the timing with that in the EU.

Looking further ahead

Pursuant to the Financial Services and Markets Bill, UK EMIR, along with the bulk of retained EU law related to financial services, is set to be rewritten, primarily in regulators' rule books. Various provisions of UK EMIR are to be split between the existing regulatory perimeter under the regulated activities order (RAO) and the proposed designated activities regime (or DAR), a new regulatory framework for the regulation of certain activities relating to financial markets. There is no formal deadline for this process, which is expected to take a number of years to complete. In the case of EMIR, it seems likely that work will commence during 2023.

More substantive changes to UK EMIR are expected to result from the Wholesale Markets Review, including exempting PTRR services from the clearing obligation. These changes are expected to be included in primary legislation as Parliamentary time allows, so not expected to come into force in 2023.

Future UK Regulatory Framework

A broad programme of work is underway to shape the future of financial services regulation in the UK. The changes will impact all financial entities that operate in the UK's financial system.

The **Financial Services and Markets Bill** delivers the outcomes of the government's future regulatory framework review. This review proposed a return to a model where regulators, rather than legislators, take on primary responsibility for setting the regulatory obligations which apply to firms. The Bill is therefore relevant to all firms operating in the UK. Although the Bill is expected to be enacted in spring 2023, it does not take effect in full straight away. The Treasury must pass commencement regulations for most provisions of the Bill before they start to take effect.

Since the end of the Brexit transition period, the UK government has described the process for retaining EU law on the statute books as a "short-term bridging measure". For retained EU law relating to financial services, the Bill sets up the process for a **"lift and shift"** of regulations off statute books and into regulators' rulebooks. This represents a significant challenge for firms to track where the rules that apply to them end up. The Treasury plans to take a phased approach, prioritising policy areas which can advance the government's objective for a more competitive, open, technologically-advanced and green financial services sector.

There are some areas of retained EU law which apply to unregulated as well as regulated entities, for example the UK Short Selling Regulation. To avoid bringing these into the scope of the regulated activities regime, the Bill empowers the Treasury to set up a new **designated activities regime**, or DAR. The Treasury would make regulations specifying the designated activities, for example activities related to entering into derivative contracts or offering securities to the public. The regulations will stipulate whether that activity is prohibited or permitted subject to compliance with certain rules. The Treasury and the FCA can both make rules which apply to the activity. Rules made under the DAR are limited to the designated activity and do not apply to other activities of the firm.

The Bill's repeal and replacement of retained EU law will take place in the context of wider reforms. A **Brexit Freedoms Bill** proposes repealing all retained EU law unless ministers restate or replace it before the end of 2023. Retained EU law relating to financial services are carved out of this deadline because these will be reformed under the Financial Services and Markets Bill. Even so, other aspects of the Brexit Freedoms Bill will apply to financial services regulation, such as the removal of the special status of retained EU law. The end-2023 deadline will also put political pressure on the Treasury and regulators to accelerate the transfer of financial services regulations.

The Financial Services and Markets Bill makes other structural changes to the regulatory framework. For example, the Bill changes the regulators' objectives. A new secondary objective for the FCA and PRA requires them to take into account the **international competitiveness** of the UK financial sector when carrying out their functions, including rule-making. The government had mooted including a "call-in" power for the Treasury to direct regulators to change their rules in some circumstances but has now shelved this idea after the regulators suggested it could undermine their independence.

Review of the overseas framework

The government is expected to consult on changes to the UK's overseas framework. This follows a 2020 Treasury paper which called for feedback on how different overseas regimes are used. These regimes include the **overseas persons exclusion**,

Further resources

- **Explore:** Future regulatory framework webpage
- **Read:** Financial Services and Markets Bill sets future for UK regulation
- **Read:** Retained EU law to expire, unless Ministers restate or replace it
- **Read:** Treasury asks whether the OPE and other aspects of the UK's overseas regime are working effectively

equivalence under UK MiFIR, the recognition of overseas investment exchanges and exemptions to the financial promotions regime. The government may look to remove overlap between these regimes. For example, as it stands, if the UK makes a positive equivalence determination under MiFIR, the OPE would not be available for firms based in the relevant jurisdiction after three years.

Other policy reforms

The UK government has launched reviews of several areas of financial regulation since the end of the Brexit transition period. More outcomes of this policy development will take shape or come into effect during the course of 2023. For example, reforms to wholesale financial markets (see our section on MiFID II), amendments to the listing rules, and changes to the regulatory perimeter to accommodate cryptoassets, new intermediaries in payments chains and buy-now, pay-later providers (see our report on Fintech and Payments). The Financial Services and Markets Bill will introduce a new critical third-party regime to allow the regulators to oversee the resilience of tech firms outside the regulatory perimeter (for more, read our section on Operational Resilience).

The government has pushed for further reform of the UK **Solvency II** regime. A 2022 consultation and Treasury response promise changes to legislation and the PRA's rulebook to give insurance firms more investment flexibility, as well as changing rules relating to risk margin and the matching adjustment.

The Financial Services and Markets Bill will amend the **financial promotions** restriction. The effect of this change is that an authorised person may only approve the content of a communication by an unauthorised person if it has permission from the FCA to approve such promotions. This is part of the new gateway for authorised firms to pass through before they can approve the financial promotions of unregulated firms. Firms are also having to implement recently imposed, stricter rules which apply when they market high-risk investments, such as unlisted shares (see our section on Putting Consumers First).

The Bill introduces a **Senior Managers and Certification Regime** which can be applied to central counterparties and central securities depositories. The Bank of England will specify the rules that will apply to these CCPs and CSDs within the SMCR. The Bill also provides for SMCR rules to be applied to recognised investment exchanges and credit rating agencies, although the government has promised further consultation on this before it brings this into effect. Separate legislation will be brought forward to apply the SMCR to recognised payment systems in due course.

Temporary permissions

The UK's temporary permissions regime is due to close at the end of 2023. Firms with temporary permission which do not receive a UK licence and cannot rely on exemptions will need to wind down their UK operations. The financial services contracts regime has been set up to help firms in this position. It allows firms five years to run off existing contracts (or 15 years for insurance contracts). Firms in the FSCR may not write new UK business and are limited to providing services which are necessary for the performance of pre-existing contracts.

The temporary recognition regime for overseas CCPs has been extended by 12 months until 31 December 2024, and the transitional regime for Qualifying CCPs (which expires depending on when the relevant firm has applied for recognition in the UK) has also been extended by 12 months. There has also been an extension to transitional arrangements for Gibraltar-based firms to provide financial services in the UK. To allow time for a new Gibraltar Authorisation Regime to be set up, these transitional arrangements have been extended by 12 months to 31 December 2023.

ESG (Outlook)

The driver for policymakers, and increasingly for supervisors, continues to be greenwashing – both in the EU, the UK and beyond. In 2023 we can expect a tightening of the concepts and terms used, with definitions of "greenwashing" being developed. This will sit alongside increasingly granular expectations around how climate and environmental financial risks are identified and monitored. Expectations for detail indicate that blaming the data may cease to be an acceptable excuse.

Greenwashing risk can take many forms, and there are increasing avenues of liability as new regulation emerges, regulators flex their muscles, new regulators (recall recent enforcement action by the UK's Advertising Standards Authority) use their powers and claimants bring more cases: this is a rapidly evolving landscape that needs to be kept under review. This review is necessary both internally – to keep track of greenwashing risk within the evolving context of the business – and externally – to keep a close eye on how policy developments impact that "greenwashing" concept.

Firms will need to think carefully about the steps they can take now to identify potential areas across their businesses for greenwashing, and how they can monitor, mitigate and ultimately try to prevent greenwashing. This includes developing a credible and consistent narrative around what greenwashing means, implementing robust internal procedures for scrutiny and developing disclosures in line with emerging UK and international standards.

Asset managers have grappled with the EU's disclosure framework since 2021, although the most granular product disclosure rules are only now coming into effect from 1 January 2023. But this does not represent the end: further developments are coming in 2023 as the EU continues to refine its approach.

Firms will also be focused on the FCA's developing disclosure and labelling regime, as well as managing the differences between the UK, the EU and other relevant regional rule sets. The core elements of the UK's proposals – labelling and classification, disclosure and naming and marketing rules – will apply to asset managers initially, but with the expectation that this could expand to FCA-regulated asset owners in respect of their investment products. Targeted rules for the distributors of investment products to retail investors in the UK have also been proposed.

On greenwashing, the FCA is making its expectations concrete, with all **regulated firms** needing to take note of its proposed "anti-greenwashing" rule. This will apply to all firms and could be in force as early as June 2023. This chimes with work undertaken in the EU to come to a definition of greenwashing, and on which the European Supervisory Authorities have asked the industry for feedback, data and examples.

Whilst disclosure has been the focus of the asset management industry, prudential reform related to climate and environmental financial risk management continues to be a key concern of the banking sector, with the PRA and the European institutions, notably the ECB and the EBA, setting their expectations for resilience in this space.

Further resources

Explore: Our Sustainable Futures blog for updates on all the ESG topics mentioned in this report

Read: Sustainable Finance Sources: Survival Guide

Explore: Our COP 27 microsite

Watch: COP27 – What does the outcome mean for businesses around the world? | Linklaters

Coming soon: for 2023 we will be launching our global Sustainable Finance Tracker. Email Victoria Hickman to find out more about it.

ESG (UK Developments)

UK Government's Net Zero Review

The Government announced a "rapid" independent review of how best to meet the UK's legally binding climate target of net zero by 2050 in a way that grows the economy and does not place undue burdens on businesses or consumers. The review has been commissioned by the Department for Business, Energy & Industrial Strategy.

The call for evidence, published on 29 September, includes questions such as:

> what challenges and obstacles have you identified to decarbonisation;

> what opportunities are there for new/amended measures to stimulate or facilitate the transition to net zero in a way that is pro-growth and/or pro-business; and

> what more could the government do to support businesses and consumers to decarbonise?

The review team had been asked to report back to the Government by the end of 2022 and despite recent political upheaval we understand that a report is still expected before the end of the year.

UK SDR

Building on its November 2021 discussion paper, the FCA has finally published its long-awaited consultation paper CP22/20 on the SDR regime and investment labels. Applicable to financial services firms as well as other corporates, the primary focus is to address "greenwashing" in financial products and provide greater clarity to investors as to how sustainable the financial products they invest in really are.

There are some important differences between the EU and proposed UK regimes:

> Unlike the EU SFDR (envisaged as a disclosure-based regime but inadvertently used as a product classification regime), the FCA's SDR proposals are explicitly envisaged as a labelling regime. The use of these labels will be voluntary (but any products that do not qualify for these labels will face limitations in terms of their marketing and naming).

> To avoid the requirements becoming too restrictive at this stage, the FCA has not embedded "do no significant harm" or PAI requirements within the eligibility criteria (albeit considerations of harm do appear in some of the example products that the FCA suggest would meet its labels).

> The FCA's proposals go further than the EU's SFDR by introducing specific obligations for distributors of investment products.

> Notably the proposals do not place specific obligations on financial advisers (who would nevertheless be caught as distributors) but we expect a separate FCA consultation on specific rules for advisers.

Notably the FCA proposes putting in place a **general anti-greenwashing rule**, applicable to all FCA-regulated firms (not just asset managers, unlike the focus of the SFDR). This cornerstone proposal will require all FCA-regulated firms to revisit their approach to ESG and sustainability across all product types (not just investment products in scope of the SDR) and disclosures.

The FCA's consultation closes on 25 January 2023. The proposal is for the anti-greenwashing rule to come into effect as soon as it publishes the policy statement on these reforms (expected 30 June 2023). All other reforms will have at least a one-year implementation period, taking effect from 30 June 2024 or thereafter.

Mandatory UK TCFD reporting requirements

TCFD reporting is already mandatory (on a "comply or explain" basis) for premium and standard listed companies in the UK under changes made by the FCA to the Listing Rules.

It is also mandatory for large asset managers and asset owners, for whom the obligation commenced at the beginning of 2022 with first reports due by 30 June 2023. The FCA's rules for asset managers and asset owners are contained in a new "ESG" sourcebook to the FCA Handbook. In 2023, the remaining UK asset managers and asset owners (excluding those below a *de minimis* threshold) will be brought within scope of the rules, with their first reports to follow by 30 June 2024.

In addition, changes have been made to the Companies Act 2006 and the LLP Act 2000 which require large UK private companies and LLPs to make TCFD climate-related disclosures in their annual reports for financial years starting on or after 6 April 2022. This obligation catches many financial services firms, including UK banks, who will need to make their first reports on this in 2023. The obligations are slightly lighter than the TCFD recommendations and are likely to require revision over time, particularly when ISSB standards become the prevailing standard adopted in the UK.

Further resources

Read: FCA outlines draft ESG disclosure rules for UK financial services

Watch: A look at the FCA's consultation on its Sustainability Disclosure Requirements

Watch: our webinar on greenwashing

Watch: our webinar on how to produce accurate and robust climate transition plans

Prudential risk management of climate and environment financial risk

In October 2022, the PRA issued a Dear CEO letter in which it reflected on progress against Supervisory Statement 3/19 (which dealt with supervisory expectations for firms' management of climate-related financial risks).

The PRA observed areas of good and bad practice, focusing on:

> Board oversight. The PRA noted that, for international firms, the boards would need oversight of climate-related metrics that are monitored across regions with management information cascaded across relevant governance forums.

> Responsible SMF. The PRA noted that the majority of firms now include an allocated SMF with responsibility for the financial risks from climate change.

> Risk Management. The PRA criticised weaknesses in fully understanding counterparties' exposures or transition plans, and noted that many banks faced challenges in sourcing this information.

> Disclosure. The PRA observed that Pillar 3 disclosures were not being used as the primary means for firms to disclose their climate risks and queried whether this is appropriate.

Looking ahead

Green taxonomy

The Green Technical Advisory Group (GTAG) has published its first independent advice to the UK government on the design and implementation of a UK Green Taxonomy. However, consultation on the taxonomy has still not been launched (despite having been expected in Q1 2022). Indications from the Treasury are that the UK's plans for its taxonomy are under review internally.

Transition planning

At COP26 last year, the UK announced its intention to require disclosure of transition plans as a key tool in the UK's pledge to achieve net zero. Transition plan disclosure is recommended by TCFD, and forms part of the FCA's mandatory TCFD reporting requirements. It will also be required under the SDRs. This echoes a global push – transition plan disclosure will be required by ISSB disclosure standards (which the UK has said it plans to mirror) – as well as requirements emerging in the EU, for example under CSRD.

In 2022, the UK Government set up its Transition Plan Taskforce whose purpose is to devise the "gold standard" for transition plans. The Taskforce published its proposed "sector neutral" disclosure framework and guidance in November. The consultation closes in February 2023 and will be followed at some point in 2023 by sector specific disclosure frameworks including for the financial services.

ESG (EU Developments)

EU Taxonomy

Climate change adaption and mitigation: The Climate Delegated Act has applied since 1 January 2022. Against the backdrop of immense controversy, a complementary delegated act amending the Climate Delegated Act to include technical screening criteria for nuclear energy and natural gas activities will enter into force on 1 January 2023. Although the Commission is facing requests for internal review, and even legal challenge for the inclusion of these two activities in the taxonomy, the Complementary Delegated Act will remain legally valid until such time as the Commission or the CJEU decide to revoke it.

Remaining 4 environmental objectives: The PSF published its final recommendations in March 2022, but the Commission has yet to adopt its delegated act covering these remaining objectives. These rules had been expected in the "autumn" of 2022 in time for a 1 January 2023 application date but, given the need to consult on any draft issued by the Commission, sights are now set on publication in 2023, with the rules applying thereafter.

SFDR the latest

After long delay, the SFDR Level 2 requirements apply from 1 January 2023. Uncertainty and complications are not over for the buy-side on this though, with further amendments to the Level 2 coming along in the course of 2023 via amendments to Level 2 and via Level 3 measures (in the form of Commission Q&As).

If you are interested in more detail on the SFDR, please read our Horizon Report for Asset Managers, or read about it in our Sustainable Futures blog.

From NFRD to CSRD

The European Parliament and Council have adopted the Corporate Sustainability Reporting Directive (CSRD), which will extend sustainability reporting requirements to 38,000 public and private sector companies. The CSRD replaces the Non-Financial Reporting Directive (NFRD), which was widely acknowledged to have been ineffectual in driving sustainability disclosures by corporates. It introduces more detailed reporting requirements on companies' impact on ESG standards, based on common criteria in line with the EU's climate goals. In scope organisations will be required to make their reports using a set of mandatory European sustainability reporting standards (ESRS) that are being developed by the European Financial Reporting Advisory Group (EFRAG) on behalf of the Commission. EFRAG submitted final drafts of the first ESRS to the Commission in November and these are expected to be adopted by June 2023.

The new CSRD rules are expected to apply between 2024 and 2028 (absent any further delay):

> From 1 January 2024 for large public-interest companies (with over 500 employees) already subject to the non-financial reporting directive, with reports due in 2025;

> From 1 January 2025 for large companies that are not presently subject to the non-financial reporting directive (with more than 250 employees and/or €40m in turnover and/or €20m in total assets), with reports due in 2026;

> From 1 January 2026 for listed SMEs and other undertakings, with reports due in 2027. SMEs can opt-out until 2028;

> From 1 January 2028 for non-EU undertakings with reports due in 2029. The position for non-EU undertakings remains to be confirmed once the official final version of the CSRD is publicly available.

Greenwashing

Call for evidence: Managing greenwashing remains an EU priority focus, and following a request for input from the Commission in June 2022 in relation to greenwashing risks and the supervision of sustainable finance policies, the ESAs have published a Call for Evidence requesting:

> views from stakeholders on how to understand greenwashing and what the main drivers of greenwashing might be;

> examples of potential greenwashing practices; and

> any available data to help the ESAs gain a concrete sense of the scale of greenwashing and identify areas of high risks.

The deadline for submissions is 10 January 2023 and contributions will feed into the ESAs' finding for their progress reports due in May 2023 (final reports due in May 2024). The Commission will use the ESAs input to develop a definition for greenwashing and to assess and monitor greenwashing risks in the financial market, with a view to the further steps needed to ensure effective supervision and enforcement in this area.

Further resources

Read: Last minute Q&A responses from the ESAs on SFDR RTS interpretation: how do they impact your disclosures?

Read: ESMA consults on developing Guidelines on funds' names with ESG or sustainability-related terms

Watch: our webinar on the EU proposal for a Corporate Sustainability Due Diligence Directive – a game changer? | Linklaters or read our alert on it here

Read: about human rights due diligence regimes in other countries Managing supply chain risks: reporting and diligence

Climate and environment financial risk management

The EBA has continued to review the integration and management of climate and environmental financial risk in the prudential framework to assess the adequacy of the CRD/CRR framework. Its conclusion so far has tended towards inclusion of ESG exposures within the existing framework (by way of CRD6/CRR3 ESG uplifts); however, the EBA is expected to provide further detailed analysis in 2023 on whether a dedicated prudential treatment for ESG risks is required.

The ECB followed its 2021 economy-wide (over 2000 euro banks in scope) climate stress test with a climate stress test of just its largest banks in 2022. The ECB concluded that climate risk is still not adequately incorporated into stress testing frameworks. Its subsequent thematic review reiterated this concern from a wider risk management perspective and has led to a punchy set of expectations and deadlines for ECB supervisions banks:

> By March 2023, banks are expected to adequately categorise climate/environmental risks and conduct a full assessment of their impact on banks' activities (for all business areas, in the short, medium and long term);

> By end of 2023, banks must have managed climate/environmental risks with an institution-wide approach covering business strategy, governance and risk appetite, as well as risk management, including credit, operational, market and liquidity risk management;

> By end of 2024, banks must be fully aligned with all supervisory expectations on climate/environmental risks outlined in the ECB's 2020 "Guide on climate-related and environmental risks" including having in place a sound integration of those risks in their stress testing framework and Internal Capital Adequacy Assessment Process.

Due Diligence

In February 2022, the Commission published its proposal for a Corporate Sustainability Due Diligence Directive (CSDDD). This sets out far-reaching due diligence requirements on a company's own operations, on its subsidiaries' operations and their value chains.

Although still unclear in many aspects, the proposal is broad and burdensome both in its geographic and its sectoral approach: it applies to both EU and non-EU companies over certain size thresholds; it also applies widely to the financial services sector.

This proposal has been subject to extensive lobbying to try to limit the scope on both these points. Sectorally, financial services trade associations have lobbied to have the financial services removed from scope altogether. Whilst this seems not to have been successful, there are early indications that asset management and funds may end up being excluded from scope or subject to lighter requirements. The banking sector, however, seems likely to remain in scope.

The Council has in recent days finalised its position on the Commission's draft. Parliament is also concluding work on its position. Once both institutions have adopted their positions, trilogues can commence; we expect this to happen early in Q2 2023.

The CSDDD is one of a suite of due diligence focused legislative proposals in the ESG space. The financial services are also keeping an eye on the EU proposal for a deforestation regulation, in which the Parliament has proposed including financial services in scope. It is hoped that this will be rejected as the compromise positions are worked out, and we expect to hear more on this and other issues around the proposed regulation before mid-December, when the nature-focused COP15 takes place in Montreal.

The UK government has announced that it will not replicate the CSDDD for the UK, on the basis that similar obligations already exist in other company legislation. It is also in the process of implementing regulations on illegal deforestation which will contain due diligence requirements.

Further resources

Watch: our video series to find out about human rights due diligence more broadly Business and Human Rights: Your questions answered

Read: the EU's Deforestation Regulation Proposal

Crypto

More regulation of cryptoassets was already in the pipeline. The high-profile failures of the last 12 months are now accelerating and helping to shape that policy work. They may also (counter-intuitively to some) embolden regulated firms to participate more in crypto markets as demand for trustworthy intermediaries increases. Whether or not this "flight to quality" materialises, 2023 is likely to be a pivotal year for cryptoassets and their interaction with the financial system.

State of play

As at the end of 2022, the licensing position of digital assets in the EU could be summarised as follows:

> **Security tokens** qualifying as financial instruments under Mi-FID are regulated, meaning that some activities relating to these (such as executing orders on behalf of clients) are regulated activities.

> **E-money tokens** which meet the definition of e-money under EMD2 are regulated under that regime, meaning that issuing this type of asset is a regulated activity.

> **Other digital assets** are unlikely to be covered by existing EU-wide financial services legislation, meaning that activities relating to these are generally unregulated (except where they overlap with other regulated activities, such as exchange for fiat currency).

The FCA's perimeter guidance on how the UK regulatory framework applies to digital assets is consistent with the above. Some EU Member States have introduced further regulation in respect of digital assets, eg France and Germany.

Derivatives referencing digital assets are financial instruments under the MiFID regime. This means that **crypto derivatives**, for example, fall within the existing regulatory framework. In the UK, the FCA has banned authorised firms from marketing, distributing or selling to retail clients derivatives and exchange traded notes that reference digital assets.

Anti-money laundering rules apply to crypto-asset exchanges and custodian wallet providers in the EU and UK. Those crypto-asset businesses must register with national regulators for the purposes of AML supervision.

Licensing changes

The policy priority is to make sure that stablecoins are brought within the regulatory perimeter. In the UK, the vehicle for doing so is an incoming regime for digital settlement assets (DSAs). Powers to create this regime will be given to the government under the Financial Services and Markets Bill which is currently before parliament.

Broadly speaking, a DSA is defined as a digital representation of value or rights that can be used for the settlement of payment obligations and can be transferred, stored or traded electronically. The Bill allows for the Treasury to draw on existing e-money and payments rules to regulate DSA issuers. This would mean, for example, that a stablecoin issuer would have to comply with the UK e-money safeguarding rules which restrict what it can do with the funds it receives.

The Bill allows the Treasury to designate operators of (potentially) systemic payment systems and systemic service providers using DSAs. These DSA payment systems and their service providers, like wallets, would be brought under Bank of England supervision, as well as being regulated by the Payment Systems Regulator. The special administration regime for financial market infrastructure will also be applied to them.

Early in 2023 the Bank of England will consult in detail on the regulatory framework that will apply to systemic payment systems and their service providers. The consultation will detail how claims on the issuer and wallets should be structured to deliver redemption at par in line with commercial bank money. It will also specify the requirements relating to corporate structure, governance, accountability and transparency.

A separate consultation from the Treasury will propose extending the regulatory perimeter to a wider range of cryptoassets and cryptoasset activities. Expect this to include rules on investor protection (such as disclosure requirements), market integrity (aping the market abuse regime) and governance.

In the EU, the provisions relating to stablecoins in the Markets in Cryptoassets Regulation (MiCA) start to apply first in spring 2024. These rules restrict the issuance of stablecoins in the EU to certain types of regulated financial institution. Only banks and e-money institutions may issue e-money tokens; only banks or MiCA-authorised issuers may issue asset-referenced tokens. The rules for other cryptoassets will start to apply in autumn 2024.

MiCA will bring in caps on volume for stablecoins. Where they are used as means of exchange and the volume of transactions reaches certain thresholds, the issuer must stop issuing the tokens and present a plan to make sure that the number

Further resources

For more on developments across the Fintech and Payments space, go to our Fintech & Payments Legal Outlook 2023

Read: UK imposes broad new rules and restrictions on promotions in the crypto industry

Read: UK confirms travel rule for crypto in changes in AML rules

Read: EU debates how to apply travel rule to cryptoassets

Read: Global banking regulator outlines proposals for the prudential classification and treatment of cryptoassets

Read: UK authorities team up to remind regulated firms about crypto standards

Read: A timeline of UK cryptoasset regulation and value remains below the caps. This has raised concerns that some prominent USD-denominated stablecoins could effectively be banned in the EU. Stablecoin issuers must also provide holders with a right of redemption which can be exercised at any time.

MiCA also establishes a regime for cryptoasset service providers. Anyone seeking to provide crypto-asset services in the EU (including, for example, custody, trading, exchange or advice) must be authorised in an EU member state for the services it wishes to undertake. For this purpose, it needs to establish a registered office in that state. Their permissions may be passported, meaning that an authorisation provided by one EU member will be valid across the EU. Authorised service providers must comply with a list of general requirements as well as the additional specific requirements applicable to the particular services they provide.

Some EU firms authorised outside MiCA may also extend their existing permissions to carry out regulated cryptoasset services. Banks, investment firms, CSDs, market operators, e-money institutions, UCITS Man-Cos and AIFMs may provide cryptoasset services subject to a notification requirement. For example, banks must give their regulator at least 40 working days' notice before providing cryptoasset services for the first time. They must also provide detailed information to the regulator about their proposed services, including descriptions of their systems and controls, marketing plans and segregation procedures.

Financial promotions

Cryptoasset ads currently fall outside the restriction on financial promotions and the FCA's rules. In 2023, the government will make regulations to extend the financial promotions regime to apply to some cryptoassets. The Financial Services and Markets Bill paves the way for this by clarifying that an "investment" for the purposes of the financial promotions restriction includes cryptoassets (broadly defined).

The FCA has already proposed how it would regulate cryptoasset promotions. Expect them to be categorised as high-risk investments in the FCA's final rules and, specifically, as restricted mass market investments. This means that mass marketing of cryptoassets to retail investors will not be banned but will be subject to restrictions.

These changes are intended to bring more "friction" into the customer journey. For example, direct offer financial promotions – which specify how investors can respond to the offer or includes a form for them to do so – to first-time investors must come with personalised risk warnings and a 24-hour cooling-off period. Only certain categories of consumer may invest, such as so-called "restricted investors" who must declare they have not invested in the last year, and will not in the next year, more than 10% of their net assets in restricted mass market investments.

AML requirements

The UK Money Laundering Regulations require firms that act as a cryptoasset exchange or custodian wallet provider to register with the FCA. By 1 September 2023, these firms must make sure they have systems in place to share additional information relating to the originators and beneficiaries of cryptoasset transfers.

The precise information to be sent with a transfer of cryptoassets depends on the value of the transaction and the location of the cryptoasset service providers. Transfers below a de minimis value threshold may be accompanied by more limited information. If all the cryptoasset service providers involved in the transaction are based in the UK, the transfer can be accompanied by less information, provided that the full information can be made available (eg to AML authorities) by other means.

Where one of the parties to the transfer is using an unhosted wallet, the information requirements will apply but only on a risk-sensitive basis. The cryptoasset exchange or custodian wallet provider must consider, for example, the value of the transfer and the frequency of cryptoasset transfers made by or to the beneficiary.

The EU will introduce a similar requirement via its recast Funds Transfer Regulation. MiCA-authorised cryptoasset service providers will need to share information about the originator and beneficiary of cryptoasset transfers. The beneficiary's cryptoasset service provider must use risk-based procedures to determine whether to execute or reject a transfer of cryptoassets which has missing or incomplete information.

Prudential regulation

Regulated firms are increasingly taking on – or planning to take on – exposure to cryptoassets. Currently, capital adequacy regulations do not provide specific requirements for cryptoassets. This is likely to change.

The PRA has already provided guidance to the firms it supervises about handling crypto-exposures. According to the PRA, its rules on market risk mean that a capital requirement of 100% of the current value of the firm's position is likely to be appropriate for "the vast majority of cryptoassets". The PRA says this is particularly the case for unbacked cryptoassets, leaving open the question of whether a different approach would be expected for digital securities and other backed cryptoassets. Firms must also manage operational risks, such as the loss of private keys by a third-party custodian. Firms that have, or are considering, exposures to cryptoassets are expected to notify the regulator of the identity of the responsible Senior Manager, any planned cryptoasset activity and the risk assessments of those crypto-exposures.

At the international level, the Basel Committee on Banking Supervision is moving towards an agreed approach on the prudential regulatory treatment of cryptoassets (very broadly defined to include digital securities and other deployments of distributed ledger technology in financial markets). This follows a 2019 discussion paper and two BCBS consultations in 2021 and 2022. The UK is expected to implement the BCBS standards once they are agreed.

IFR/IFPR

UK IFPR – where are we now, and what to expect in 2023?

As the first year under the new UK prudential regime for investment firms draws to a close, 2023 will see regulatory expectations move on from compliance on a "best efforts" basis to firmer expectations. Firms will also focus on their first public IFPR disclosures and continue work on refining their governance structures.

Supervisory expectations: ICARA & SREP (Pillar 2)

The FCA has been busy undertaking supervisory review and evaluation processes (SREPs) in H2 2022, starting with those larger IFPR firms that submitted their first internal capital and risk assessment (ICARA) forms (MIF007) early. We expect the FCA to publish its first observations from these early SREPs by the end of 2022 / in early 2023, and we understand that messages will likely include the following:

- **ICARA should be more holistic:** The ICARA process is made up of different parts, namely identifying potential material harms the business may pose to clients, markets and the firm itself; putting in place processes to mitigate these; undertaking stress testing (and possibly reverse stress testing); setting triggers and recovery actions to save the business; putting in place a wind-down plan; and identifying any additional capital or liquid assets which may be required to enable the firm to operate through the economic cycle and to wind-down in an orderly way, if needed. The FCA would like firms to pull these different strands together, through **senior manager / board involvement**, so that the business model and risk appetite of the firm are properly reflected in any stress testing and, in turn, in the firm's triggers / thresholds for recovery action and a potential wind-down.
- Given that wind-down planning is new for all IFPR firms, it is not surprising that this is a focus area of the FCA. There have been several FCA publications that are relevant to **wind-down planning and related liquidity needs**. Beyond the FCA's Wind-Down Planning Guide, FCA Finalised Guidance 20/1, and FCA Thematic Review 22/1, the FCA has also published findings from its review of liquidity and orderly wind-down in general insurance brokers, which includes commentary that will be of wider relevance to IFPR firms (eg on the need to consider group relationships, and senior manager involvement). IFPR firms should reflect these FCA expectations carefully in their ICARA processes, as we expect this to be a continued FCA focus for 2023 (particularly given current economic outlook).
- The FCA also expects IFPR firms to reflect **feedback from previous (pre-IFPR) SREPs** or to discuss relevant changes in circumstances with the FCA.
- As the FCA is becoming more data led, and because data from the various MIF reports is used to identify prudential risks that may impact UK markets, the regulator expects firms to focus on **data accuracy**. In 2022, the FCA clarified some of the MIF forms and guidance to improve data quality, and we can expect sharper FCA focus on firms that get it wrong during 2023.

All IFPR firms should be completing a first review of their ICARA processes by the end of 2022 (since the review is required annually). Any IFPR firms that have not yet submitted their first ICARA report (MIF007) to the FCA will need to do so in early(ish) 2023. We expect the FCA to continue its SREPs throughout 2023 – and this will likely involve **the first "sectoral" SREPs** where FCA feedback may be directed at whole sectors rather than individual firms.

IFPR disclosures (including remuneration and ESG disclosures) (Pillar 3)

In 2023, the first public disclosures under IFPR will be due. The **types of IFPR disclosures** required depend on the classification of the relevant firm, with:

- non-SNI firms required to make disclosures on risk management, own funds, own funds requirements, governance arrangements, remuneration and (if the non-SNI firm is above the committee threshold) its investment policy and more detailed information on remuneration structure and material risk takers (MRTs);
- SNI firms with AT1 capital required to make disclosures on risk management, own funds and own funds requirements; and
- all SNI firms required to make a minimum level of remuneration disclosure about the key characteristics of the remuneration policy.

Public IFPR disclosures are due **annually**, and **first disclosures** will be due as follows:

- Public IFPR disclosures will be due on the date on which the relevant investment firm publishes its financial statements (or, if it does not publish financial statements, the date on which it is required to submit its solvency statement to the FCA).

Further resources

Explore: Our IFR webpage

Read: Our briefing summarising IFPR remuneration disclosures for all investment firms

- For firms whose **financial year ends on or before 30 December 2022**, the first IFPR disclosures on own funds, own funds requirements and governance will be made from their 2022 year end date (ie for the first time on the date the firm's 2022 financial statements are published). Risk management and investment policy disclosures (to the extent applicable to the firm) only start from their 2023 year end date (ie are first due on the date the firm's 2023 financial statements are published).
- For firms whose **financial year ends on 31 December 2022**, the first IFPR disclosures on own funds, own funds requirements and governance, as well as risk management and investment policy disclosures (to the extent applicable to the firm) will be due on the date the firm's 2022 financial statements are published.
- The **timing of the first IFPR remuneration disclosures** does not depend on a firm's year end date. IFPR remuneration disclosures are first due after the **end of the first performance period commencing on or after 1 January 2022**. Like the other IFPR disclosures, remuneration disclosures will be due on the date on which the firm publishes its first annual financial statements following the end of that first performance period.

IFPR firms will be busy pulling together relevant data, and decisions about proportionality in the context of qualitative disclosures will be key.

As regards **ESG disclosures**, the FCA had delayed this aspect of the IFPR regime while ESG standards were still evolving globally. But we expect an FCA consultation on IFPR ESG disclosures before the end of 2022, and firms will be busy engaging with this (including, where groups operate across the UK and EU, assessing whether and how relevant ESG disclosures can align across the regions).

Governance

We expect firms to continue their focus on establishing governance structures in line with the IFPR requirements in 2023, noting that some groups with non-SNI firms that are above the committee thresholds continue the recruitment process for the required NEDs and their work on entity and group committee structures (or may be applying for waivers from the FCA to be permitted to hold certain committees at group level).

Given the FCA's comments on the ICARA process (see above), firms should also assess the governance of their ICARA processes, and in particular the level of senior manager and board level input to ensure that ICARA is run holistically and reflects the firm's risk appetite and specific material harm profile throughout, including when setting recovery and wind-down triggers.

2022 saw much discussion of the change of the definition of "significant IFPRU firm" to "significant SYSC firm", which (due to the low commission threshold) would have meant that many portfolio managers and investment advisers would be caught and subject to enhanced SMCR requirements. An FCA consultation proposed to limit the changes to firms that would have been IFPRU firms prior to commencement of the IFPR regime, but to do so for SMCR purposes only. This means that relevant firms could still be subject to other provisions which apply to "significant SYSC firms", most notably the limits to directorships. We expect the FCA's final position on "significant SYSC firms" by the end of 2022 or in early 2023.

Remuneration

IFPR introduced a new remuneration regime for performance periods starting on or after 1 January 2022 for all UK investment firms, the "MIFIDPRU remuneration code" (SYSC 19G in the FCA Handbook). Firms have been navigating new complex rules and some challenging issues, including the following:

- Scope: Identifying MRTs on the basis of qualitative criteria only, particularly those based outside the UK, and the impact on their pay, and treatment of UK branches of third-country firms;
- What does "risk adjustment" mean in relation to bonus pools, the process involved, and what will be the FCA's approach to assessing remuneration practices; and
- Pay-out structure: Appropriate deferral periods, regulatory and HR impacts of setting a high fixed-variable pay ratio, using parent company shares for the non-cash instruments requirement, and alignment and treatment of severance pay.

These will continue to be addressed during 2023 as the rules bed down. Experience of similar issues which banking groups have had to deal with in the context of the CRD regime may be of some assistance.

EU IFR/IFD – where are we now, and what to expect in 2023?

In the EU, although the new prudential regime for EU investment firms has been in place slightly longer, several Member States implemented the requirements late. For 2023, we expect the areas of focus of NCAs and EU investment firms to be broadly similar to those outlined for the UK IFPR above, with regulatory expectations growing beyond "best efforts" compliance.

As different NCAs complete SREPs for larger firms in their relevant market, in 2023, we will start to see observations about implementation and required improvements, most likely (as in the UK) on data accuracy and the new ICARA processes, particularly on the new wind-down planning requirements and related liquidity. The challenge for some firms that are part of investment firm groups will be to navigate and reflect the nuances of commentary from different NCAs.

IFR public disclosures (Pillar 3) and ESG

Unlike UK IFPR firms, EU Class 2 investment firms, and Class 3 investment firms with AT1 capital, have already had to complete their first annual (Pillar 3) disclosures (which cover the same ground as those outlined in the UK IFPR section above). These disclosures were due when relevant firms published their first annual financial statements after 21 June 2021 (when IFR started to apply).

But (unlike the UK IFPR), from 26 December 2022, the EU regime (Art 53 IFR) requires Class 2 EU investment firms to disclose information on ESG risks, including physical risks and transition risks (which are defined in the 2021 EBA report on the management and supervision of ESG risks for credit institutions and investment firms, and as complemented by the EBA's October 2022 report on incorporating ESG risks in the supervision of investment firms). These ESG disclosures will need to be made once in the first year (ie when a Class 2 firm next publishes its annual financial statements after 26 December 2022), and biannually thereafter.

On the treatment of ESG risks, the EBA is also mandated to publish its report under Article 34 IFR on the prudential treatment of assets exposed to activities associated with environmental or social objectives (which was originally due in December 2021). The EBA's May 2022 discussion paper on the role of environmental risks in the prudential framework explores the interaction of environmental risks with the CRR and IFR/IFD prudential frameworks, and considers whether certain aspects of the IFR/IFD regime (including K-Factor calculations) could be amended to specifically incorporate environmental risks and/or to what extent changes to the IFR/IFD regime could reflect similar changes to the CRR prudential regime applicable to credit institutions, subject to the principle of proportionality. The outcomes from this discussion paper should feed into the EBA report under Art 34 IFR, which we expect during 2023 (possibly as soon as Q2 2023).

IFR/IFD "Class 1" group test

At the moment, the test that determines whether an EU investment firm is a "Class 1" firm and therefore subject to the CRR prudential regime, instead of IFR/IFD, includes a group test. As discussed in this earlier client note, the global reach of this group test can lead to Class 1 classification where own account dealing, underwriting / placing activities of a global group exceed relevant thresholds, even where only a minimal level of these activities is carried on by an EU group entity. We are aware that the Czech Council Presidency recently proposed to amend the group element of the "Class 1" test so that it only takes account of EU firms within the group which conduct the relevant activities / relevant EU assets (ie changing this from a global to an EU group test). This would be a welcome change for some global groups. It appears that this potential change may be included in the Council compromise amendments to MiFIR (as part of the EU MiFID Review). Please refer to our section on MiFID II for more detail on the expected timings of the EU MiFID Review. But if this proposal is accepted during trilogues, this change could become effective towards the end of 2023 or in early 2024.

CRD 6 – Cross border business

Towards the end of 2021, the European Commission put forward draft legislation that would have required a non-EU firm to establish a branch in the EU before being able to provide banking services in the EU.

This proposal was delivered as part of the EU's Banking Package which introduced a new CRD6 and CRR3, as well as changes to the Bank Resolution and Recovery Directive regime.

As then drafted, CRD6 would have required many non-EU banks to set up authorised branches in the EU to do, or carry on doing, banking business in the EU. Furthermore, unclear drafting in the original proposal meant that the scope of this requirement could have extended beyond banks and larger investment firms.

The proposals would therefore have ended national cross-border licences and exemptions which enable cross-border services.

These controversial proposals met with intense criticism, especially amongst US headquartered banks, and to the relief of the banking, and wider financial services sector, seem now to have been watered down significantly.

The proposed changes to CRD 6, including the controversial Art. 21(c) that would have required third-country firms servicing EU clients to establish a branch in the EU, have not been formally adopted.

Instead, it has been proposed that the third-country branch proposal be replaced with an obligation on the EBA to publish a report on third-country access to EU markets, due in 2025.

The position has not been finalised as yet and needs to go through the EU legislative process.

The next step is for the Parliament and the Council to prepare their compromise versions of CRD 6, from which trilogue negotiations may commence.

On the European Parliament's side, the responsible committee was scheduled to have a vote on its draft report (which includes several suggested amendments to the proposed Article 21(c) in August) on 5 December. This has been delayed and is expected to happen in Q1 2023. Once formally adopted, the report will constitute the European Parliament's negotiating position vis-à-vis the Council.

On the Council's side, the CRD6 compromise text (not yet public) does not include the proposed Art. 21(c) wording. This compromise text was formally adopted by the Economic and Financial Affairs Ministers on 8 November in the form of a General Approach.

Depending on Parliament keeping to its timeframe, and on various factors including the priorities of the incoming Swedish Presidency of the Council of the EU, trilogues may begin in Q1 2023. Current predictions are that CDR6 will not be in force before Q3 2023 at the very earliest, as it is thought that these trilogue discussions will likely not proceed smoothly.

However, the direction of travel at this point in time is that the Art. 21(c) obligation looks likely to be removed and replaced by an obligation on the EBA to publish a report on third-country access to EU markets.

Operational resilience

How would you show you are ready to withstand a cyber-attack, failed IT upgrade or an outage at a service provider? New and incoming rules on operational resilience expect UK and EU firms to follow a more prescriptive approach when preparing for disruption. Financial services authorities are also taking on more responsibility for overseeing unregulated tech providers to monitor and mitigate concentration risk in the sector.

UK operational resilience regimes

The UK's operational resilience regimes – one set by each of the FCA, PRA and Bank of England – are now in force. Firms in the scope of these rules should already have set impact tolerances for all their important business services and mapped the resources they rely on to deliver these services. They will also have drawn up "self-assessment" documents evidencing how they comply with the new rules. These records must include justifications and explanations for key decisions made during implementation. The challenge for firms is to maintain these documents so that they are up to date when the regulators request them.

Firms are now focusing on building out the sophistication of their mapping exercises and scenario testing. This is so that vulnerabilities can be addressed no later than the 31 March 2025 deadline. After this date, firms must remain within impact tolerance levels in the event of severe but plausible disruption. Firms will want to use feedback from testing to calibrate their impact tolerances over the next couple of years before this rule starts to apply.

Senior management will be held to account for delivering operational resilience. The board must approve and regularly review the (potentially voluminous) documentation which records compliance with the regime. The FCA has made clear that responsibility for signing off operational resilience documents should not be delegated to someone that is not on the board.

To meet the rising regulatory expectations, senior management will need to receive more status updates on their institution's resilience. This management information, including incident reports, should be timely and offer appropriate detail. Training and advice should be made available to ensure that they can engage with this information and oversee the real resilience of the business effectively.

The PRA's introduction of new guidance on outsourcing and third-party risk management (SS2/21) has supplemented existing outsourcing requirements for dual-regulated firms. The guidelines set out the regulator's expectations on how PRA-supervised entities should manage third-party risks, including those relating to cloud services. The guidance covers not only outsourcings but also non-outsourcing arrangements with third parties. There is no equivalent UK-specific guidance from the FCA. Instead, the FCA continues to have regard to the retained version of the European Banking Authority's guidelines on outsourcing which apply to PRA-regulated firms and payment and e-money institutions.

Expect to see regulators reiterate these relatively new standards over the course of 2023 as they push the financial services industry to consider resiliency across their supply chains. Firms applying for authorisation can expect both the FCA and PRA to raise questions about how they propose to be operationally resilient.

Expect to see regulators reiterate these relatively new standards over the course of 2023 as they push the financial services industry to consider resiliency across their supply chains. Firms applying for authorisation can expect both the FCA and PRA to raise questions about how they propose to be operationally resilient.

New rules are also in the pipeline. For example, the FCA, PRA and Bank of England plan to consult on operational incident reporting requirements for firms and financial market infrastructures. This underlines what many in the industry have already recognised, which is that operational resilience is not a regulatory change project with an end-date but rather an ongoing exercise.

UK critical third party regime

Encouraging individual firms to build their resilience to operational disruption is only one piece of the puzzle. Another relates to the systemic risks that can emerge where several regulated entities rely on a common service provider. To better monitor and mitigate this concentration risk, the UK regulators will be empowered to oversee some unregulated tech firms providing critical services to the regulated sector.

The Financial Services and Markets Bill sets the oversight regime for critical third parties. Once the Bill is enacted and the relevant provisions brought into force, the government may designate a person who provides services to financial services firms or financial market infrastructure as a "critical third party". This designation would be on the basis that the failure of, or disruption to, those services could

Further resources

Explore: Our resources on operational resilience

Explore: DORA Explored: How the EU's rules for digital operational resilience affect you

Explore: Cyber Security Handbook – The Essential Handbook for In-house Counsel

Explore: A guide to the EU's new digital package

threaten the stability of or confidence in the UK financial system.

When making a designation, the Treasury must take into account two factors. The first is the materiality of the services to the delivery of activities that are essential to the UK economy or to the stability, or confidence in, the UK financial system. The second is the number and type of recipients to which the third party provides services. Notice must be given to the potential critical third party and a reasonable period allowed for written representations.

The FCA, PRA and Bank of England will make rules in connection with the provision of critical services. They are expected to use these powers to introduce minimum resilience standards for critical third parties and to require them to take part in a range of resilience tests and sector-wide exercises. The detailed rules will be the subject of a consultation paper in 2023. The Bill also gives the regulators additional investigatory and enforcement powers to supervise and enforce the regime once it starts to apply.

EU DORA

Over 20,000 firms in the EU will need to get themselves ready to implement the digital operational resilience act, or DORA. The regulation aims to harmonise higher resilience standards across the EU and across different sectors of the financial services industry. Virtually all EU regulated financial entities will be in scope.

DORA obliges firms to take a more robust approach to ICT risk management. Like the UK regime, DORA expects sources of ICT risk to be identified, interdependencies mapped and risk tolerance levels set. Resilience documentation must be consolidated and made available to regulators.

DORA includes rules on testing, responding to lessons learned and setting a communications strategy. Unlike the UK regime, DORA explicitly requires firms to use up-to-date, reliable and resilient ICT. It also specifies that the management body is ultimately responsible for managing ICT risks.

A significant headache for many firms is the challenge of implementing a global resilience strategy in a way which is compliant with local regimes. Although the outcomes of the UK and EU regimes are largely aligned, the detailed requirements differ. For example, DORA's concept of a risk tolerance limit is not the same as the UK definition for impact tolerance. Other jurisdictions are also developing rules aimed at building the operational resilience of their financial sectors.

DORA includes an equivalent to the UK's critical third party regime. It allows the European Supervisory Authorities to designate and directly oversee what DORA calls "critical ICT third party service providers". The definition of "ICT services" is widely drafted and will include not only cloud provision but a range of other digital and data services as well.

The assessment for whether a provider is designated as "critical" takes into account the systemic impact that disruption of the third party could have on the stability, continuity or quality of financial services. This includes considering the degree of substitutability of the services and the number and importance of the financial entities receiving the services. One of the ESAs will be appointed as Lead Overseer for each critical ICT third party service provider.

There are exceptions to the designation process. For example, it does not apply in relation to:

> financial entities providing ICT services to other financial entities;

> ICT third party service providers that are subject to other EU oversight frameworks; and

> intra-group service providers.

These exemptions are important because of the requirements on critical ICT third party service providers. For example, one of the requirements in DORA is that EU financial entities cannot use a critical ICT third party service provider based outside the EU unless that third party sets up a subsidiary in the EU within 12 months of designation. This will be particularly impactful for overseas tech firms currently providing services into the EU.

Although designation falls short of authorisation as a financial entity, DORA gives the ESAs wide powers over critical ICT third party service providers. The Lead Overseer is responsible for assessing whether the provider has comprehensive, sound and effective rules, procedures, mechanisms and arrangements to manage the ICT risks they pose to financial entities. It will have the right to request or require access to information, including relevant business and operational documents, contracts, policies, security audit reports and incident reports. The Lead Overseer will also have broad powers to conduct investigations and on-site inspections of any premises of critical ICT third party service providers, including overseas premises.

DORA takes effect after a two-year transition period. This means its requirements are expected to start applying from 1 January 2025. As well as setting up the various processes relating to the oversight regime for critical ICT third party service providers, the European Supervisory Authorities must develop over twelve sets of technical standards. Most are due by the end of 2023. These include more detailed requirements about financial entities' ICT response and recovery plans, ICT business continuity processes, and contractual arrangements for critical and important functions. ESMA also plans to finalise its opinion on market outages in early 2023.

This wave of technical standards presents a resourcing challenge for the ESAs. It also has the potential to complicate matters for firms around halfway through their DORA implementation projects.

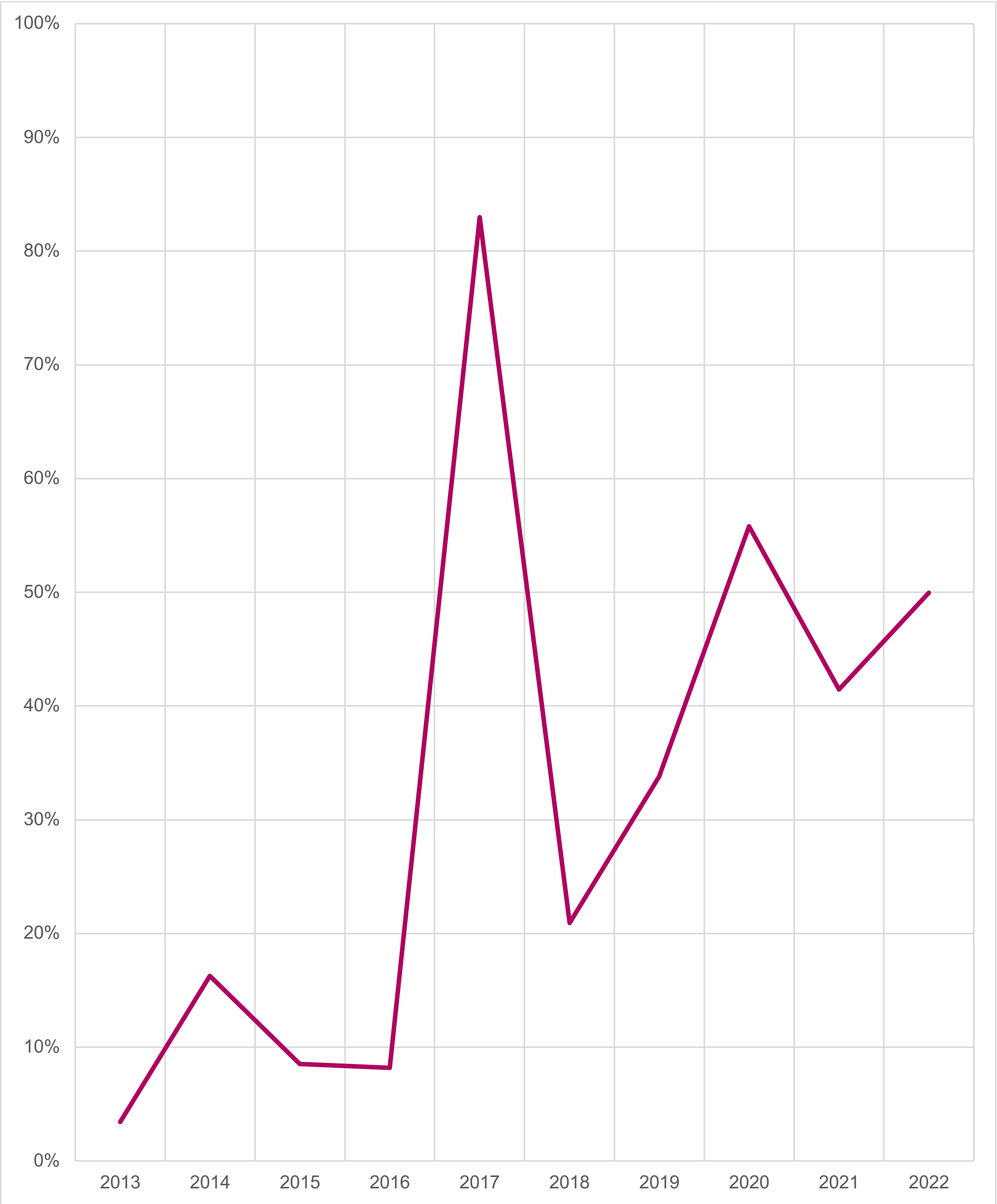
Market conduct: a focus on AML and Sanctions

A consistent message from regulators – but it's harder for firms to execute

In 2023, AML and sanctions risk management will be more fraught than ever.

UK regulators are highly focused on this area, as illustrated by their substantial and sustained levels of financial crime enforcement actions which now make up at least half of their total fines.

Total GBP FCA/PRA fines, financial crime as % of total, by calendar year



Nothing's changed in the UK regulators' key messaging: that financial crime (including AML and sanctions) are key risks, and that firms should manage them holistically, recognising the substantial overlap in the controls needed for the various financial crime risks.

But this will prove ever more challenging for firms.

UK AML reforms, postponed perhaps by UK Government ructions, should get back on track in 2023. These will produce increasing divergence between UK and EU requirements, with the EU full steam ahead on its own AML regulatory consolidation and reform agenda.

And sanctions have proliferated as geopolitical tensions intensified (in particular the Ukraine crisis). The accompanying rapid-fire UK regulatory reforms are producing new compliance headaches for firms. These will persist into 2023.

Firms that fall short of regulatory expectations will face the long tail of enforcement risk. And in this challenging environment, it's growing more difficult to avoid becoming lowest-hanging fruit for investigators.

Sanctions

2022 saw a proliferation of sanctions addressing geopolitical tensions, in particular the Ukraine crisis, affecting a wide range of economic activities including energy (accompanied by a price cap), shipping including maritime insurance, and various financial instruments and investments, and various commodities. These have created significant compliance challenges for financial services firms grappling with the sanctions themselves and the various general licences (containing exemptions) including those for payments to UK insurers and service fees for bank accounts.

The FCA responded in particular to the impact on funds by making rules allowing funds to establish "side pockets" to isolate sanctioned assets.

These sanctions show no sign of abating in 2023 and so will cause continuing headaches for compliance teams, especially those supporting EU and other cross-border businesses to which multiple jurisdictions' sanctions regimes may apply.

Further resources

- **Read:** six months on – Changes to international business since Russia's invasion of Ukraine (Aug 2022)
- **Read:** UK Sanctions reporting: Cryptoasset exchange and custodian wallet providers now subject to enhanced sanctions reporting requirements; firms' annual frozen assets reports due soon (Sep 2022)
- **Read:** the new EU Commission AML/CFT legislative package revealed (Aug 2021)
- **Read:** safe travels: UK confirms travel rule for crypto in changes in AML rules (Jun 2022)
- **Read:** Bill published to take forward Companies House shake-up (Sep 2022)

The UK position may become more fluid given that the Economic Crime (Transparency and Enforcement) Act 2022 introduced a streamlined process to impose sanctions on an expedited basis. Plus this Act raised the stakes by effectively enabling OFSI to impose strict civil liability for sanctions breaches (penalties can be considerable). And the Act now requires OFSI to publish reports on its monetary penalties and where it has not imposed penalties but nonetheless is satisfied that breaches have occurred – effectively a "naming and shaming" power which could have real reputational consequences. Finally, cryptoasset exchange providers and custodian wallet providers are now brought within UK sanctions regimes and must now comply with enhanced sanctions reporting obligations.

To bolster compliance efforts, the UK Government is focusing on improving the central collection of reliable information on beneficial owners of assets. The Economic Crime (Transparency and Enforcement) Act 2022 creates a new register of overseas owners of UK property, to be operated by Companies House. And the UK Government's Economic Crime and Corporate Transparency Bill aims to improve the integrity and quality of data on the Companies Register (as noted above).

Into 2023, firms should maintain their focus on, and resourcing of, sanctions controls to ensure compliance and mitigate later enforcement risk. Firms that combine their sanctions, AML and other financial crime controls work into a holistic assessment and improvement projects may enjoy the benefit of some helpful synergies and tailwinds – noting the regulators' messaging that firms should manage these risks holistically and the substantial overlap in the controls that are required.

UK AML reforms

The MLRs requirement to report material discrepancies between KYC information and information held by Companies House on an ongoing basis will take effect on 1 April 2023. And by September 2023 the UK's 2022 amendments to the Money Laundering Regulations (MLRs) will come fully into force. These amendments:

> Give AML/CTF supervisors and UK AML authorities wider gateways to share information and intelligence.

> Adopt the globally standard definition of Proliferation Financing.

> Extend CDD and Companies House registration (and discrepancy reporting) requirements to cover all business types including trust and company service providers and limited liability partnerships.

> Implement the "travel rule" for cryptoassets.

The Economic Crime (Transparency and Enforcement) Act 2022 creates a new register of overseas owners of UK property, to be operated by Companies House. It also strengthens the system of Unexplained Wealth Orders (UWOs).

The UK Government's new Economic Crime Levy on MLRs-regulated businesses will first fall due in the 2023-24 reporting year. This Levy will help fund the Government's AML efforts.

The UK Government's Economic Crime and Corporate Transparency Bill is likely imminently to become law largely in its present form. At least some of its provisions could take effect during 2023. The Bill:

> Aims to improve the integrity and quality of data on the Companies Register including by requiring the Registrar to verify identity (backed by criminal liability for negligently misleading the Registrar and civil penalties powers). This will in turn substantially increase compliance cost and burden for financial services firms interacting with the Companies Register.

> Addresses more business types. It would tighten registration, transparency and activity requirements for limited partnerships, and would extend criminal confiscation and civil recovery powers to cryptoassets.

> Intends to reduce obstacles to information sharing. It would enable businesses in certain situations to share information more easily to counter economic crime, by disapplying civil liability for breach of confidentiality in those contexts. And it would enable the NCA's Financial Intelligence Unit (FIU) to obtain AML/CTF information from a business even where the business has not first made a Suspicious Activity Report (SAR).

> Would expand the types of case in which businesses can deal with clients' property without having to first submit a Defence Against Money Laundering (DAML) SAR.

The Government is likely to respond in 2023 to HMT's 2021 consultation on the UK AML regime – a response perhaps delayed by UK Government instability but likely now imminent given that the FATF is due in 2023 to conduct its 5th year follow-up of its – largely positive – 2018 mutual evaluation of the UK's AML/CTF regime. The content of the response is difficult to predict given the wide-ranging nature of the consultation: it reviewed the systemic functioning of the regime including regulators and their supervisory and enforcement approach, and considered possible regulatory

Further resources

Read: The UK strengthens its response to money laundering and corruption with the Economic Crime (Transparency and Enforcement) Act 2022 (Mar 2022) reform including to support risk-based decision making particularly around CDD, support adoption of new technology to improve controls, maximise the utility of Suspicious Activity Reports (SARs), prevent entry of bad actors into the regulated sector, and give sector-specific guidance for industry participants.

These actual and proposed reforms will make important additional resourcing demands on firms:

> Additional KYC/CDD resource will be needed to meet firms' obligations to support the expanded role of the Companies Register.

> Additional compliance resource will be needed to request – and respond to requests – for information to counter economic crime via the disapplication of civil liability for breach of confidence. These requests may be nuanced and involve considerable commercial sensitivities.

> Additional compliance and legal resource will be needed to respond to the NCA FIU's use of wider information gathering powers.

In the meantime, regulators and regulated firms are attending to concerns about money laundering and financial crime concerns relating to funds advanced under government supported Covid-19 loans. And UK regulators (including HMT) are engaged in questions of appropriate cryptoasset regulatory reform. The focus is presently on systemic safety and soundness, but some strengthening of cryptoasset AML regulation is possible in the medium term.

EU AML reforms – and EU-UK divergence

The EU is planning a package of AML reforms including uniform regulation and a single EU AML authority (the AMLA), as well as a recast revised Wire Transfer Regulation (WTR) prioritised in the view of the need for a cryptoasset "travel rule" to ensure transfer traceability. Originally slated for adoption in 2022, we now expect these reforms to be adopted in 2023. The full regime would come into force three years later, giving the AMLA time to prepare technical standards. The regime would among other things:

> Widen the scope of the regime including to cover all cryptoasset service providers, crowdfunders, and mortgage and consumer credit firms.

> Strengthen internal controls requirements, including individual accountability and group-wide (and parent) measures.

> Clarify Customer Due Diligence (CDD) measures, including identification and verification, electronic identification, and use of standard datasets.

> Streamline the identification of high-risk third countries.

> Clarify how entities can rely on third party CDD.

> Harmonise suspicious activity reporting.

> Give clarity on data protection.

> Cap cash payments at EUR10,000.

> Revise beneficial ownership rules.

> Implement cross-border connection of national bank and payment account registers.

The EBA expects in 2023 Q2 to issue guidelines on de-risking; and in 2023 Q4 to issue guidelines on policies, procedures and controls to support the implementation of restrictive measures, revised guidelines on money laundering and terrorist financing (ML/TF) risk factors, revised guidelines on transfers of funds, and revised guidelines on risk-based supervision.

As we observed last year, the UK and EU are both committed to FATF's standards so their AML efforts will broadly align, but it's the specifics that could trip up firms – so firms should engage in granular review and adjustment of their processes. Over time we may see divergence between the EU and UK in relation to the firms falling within scope, requirements applying to group entities, criteria for EDD/SDD, digital identification requirements, when a firm may rely upon outsourced CDD, balancing information gathering and data protection, and large cash payments.

Putting consumers first

Policy and Outlook

The FCA is committed to setting clearer and higher expectations for the standards of care and customer service that firms give to consumers. The FCA has set itself demanding metrics against which to measure future success and is focused on becoming more data-led and agile, intervening earlier to prevent harm

With the advent of the new Consumer Duty, the FCA expects firms to consider whether they are contributing to good customer outcomes (including for those with characteristics of vulnerability) through their activities at every stage of the customer journey.

Policy

FCA focus on consumer wellbeing and protecting vulnerable customers has continued throughout 2022:

- Continued work following the publication in 2021 of guidance on the fair treatment of vulnerable customers resulted in further guidance from the FCA on the areas where it has not yet seen the improvement it expects.
- The FCA's latest Financial Lives research suggests that 47% of UK adults now have characteristics of vulnerability, and 24% of all UK adults now have low financial resilience, emphasising the importance of firms embedding the FCA recommendations.
- The importance of financial inclusion is emphasised and the FCA will be monitoring closely to ensure that measures that it puts into place (such as the consumer duty) do not prompt risk aversion in firms (or even the withdrawal of products for difficult to reach groups).

Particular emphasis is also placed on the current cost of living crisis. The FCA has set out its expectation that firms reflect on the likely impact of this on consumers and proactively take the necessary steps to support them and mitigate harm.

The FCA's Consumer Investments Strategy remains a focus and the FCA reports having placed restrictions on twice as many firms in the investment market compared to last year, as part of its strategy designed to prevent harm in the consumer investment market.

Financial promotions

The FCA of course expects consumers to take responsibility for their choices and decisions. Nevertheless it emphasises that consumers' ability to do so may be limited, not least because they don't have access to the information they need to make informed decisions at the time they need it.

With this in mind, new rules are coming into force which will strengthen financial promotions rules for high risk investments and the firms approving financial promotions.

The enhanced financial promotions requirements are relevant to private wealth managers and asset managers making financial promotions of relevant high-risk investments to retail clients, and to firms who approve the financial promotions.

The FCA has "rationalised" high-risk investments into two categories (restricted mass market investments / RMMIs and non-mass market investments / NMMIs) and has introduced "frictions" into the customer journey when relevant products are promoted to retail investors. These include specified risk warnings and risk summaries, which are required from 1 December 2022. Other enhancements to the customer journey, and new guidance for firms approving financial promotions, apply from February 2023.

Connected with this, the FCA has set out its plans for how it plans to operate a new "gateway" for firms which approve financial promotions for unauthorised persons. The gateway will be created by the Financial Services and Markets Bill which tightens the existing financial promotions restriction. Under the gateway, firms that want to continue to be able to approve promotions will need to apply to the FCA for permission to do so. The FCA's rules which set out how firms can seek this permission are expected to be finalised in the first half of 2023.

Outlook

Flowing from the FCA's pivot to an outcomes based regulatory landscape, firms should expect greater emphasis on outcomes as a measure of compliance, and as a basis for new regulation. This will be seen most prominently in the work undertaken to implement the consumer duty (see further below) as the FCA works with firms to identify examples of good and poor practices. The FCA has highlighted its commitment to making use of its supervisory powers to take quick and effective action to address harm where it sees poor practice, including in cases where products or services may not be regulated.

Given the deteriorating economic context and the cost-of-living crisis the FCA will also continue to review the Consumer Investments Strategy (with a report on progress in 2023) and will reinforce its work where it identifies growing consumer harm.

Further resources

Read: Our report on the FCA's 2022 strategy and Business Plan

Explore: Our Consumer Duty webpage

Read: Our client note on the enhancements to the financial promotions regime

Putting consumers first: Spotlight on the Consumer Duty

With implementation plans for the Consumer Duty finalised by the end of October 2022, firms will be looking ahead to the next phase of their implementation journeys.

Firms that are proactive at this early stage will more confidently meet the FCA's deadline for implementation and be better placed to meet the Duty as part of their BAU operations post go-live.

The FCA's new Consumer Duty heralds the largest shift in a decade in the FCA's expectations around firm's treatment of retail customers and will capture activity by retail and wholesale firms.

The Duty's outcomes-focused approach is intended to give firms more flexibility to tailor implementation to meet the demands of their businesses and to apply more readily to future technological and market developments than a more static, rules-based regime.

The FCA intends to measure the success of the Duty by measures that include monitoring FOS decisions and feedback gathered through its Financial Lives Survey and will develop additional metrics over time.

Next steps

Scoping: The focus for firms should now be on putting their implementation plans into action – and the first step will be on determining to what extent the new rules apply to their products and services.

Gap analysis and product review: Once scoping concludes, firms will need to understand what uplifts to existing policies and procedures will be needed to comply with the Duty. Manufacturers are also expected to complete reviews of all their products by April 2023, to enable information relevant to the products and services, and price and value, outcomes to be communicated to distributors in good time.

Monitoring and governance: The FCA will expect firms to clearly articulate their plan for monitoring compliance with the Duty going forward, and to establish an effective ongoing governance framework (the role of MI and data will be key). Firms' cultures will need to evolve to accommodate the higher standards within the Duty and extensive internal training of staff at every level will be required.

Interaction with the FCA

The FCA has committed to engaging with firms and being more open and agile in responding to the market and promoting good practice. In return, firms are expected to engage with the FCA, particularly if, as a result of their work implementing the Duty, they are considering withdrawing or restricting access to any products or services in a way that will significantly impact vulnerable customers or overall market supply.

The FCA reached out to some firms promptly upon expiration of its October 31 soft deadline for board sign-off of implementation plans, requesting details of their implementation planning. Firms should expect ongoing dialogue with the FCA as the Duty beds down.

Looking ahead

The full set of rules will apply on 31 July 2023 to new and existing products that are open to sale or renewal. The implementation deadline for closed products or services arrives one year later on 31 July 2024.

The July 2023 deadline is challenging. The FCA has noted that most firms appear to be well on track and sees no need to move the deadlines again. Helpfully the FCA has nevertheless reiterated its intention to remain pragmatic in its oversight of implementation.

Further resources

- **Explore:** Our Consumer Duty webpage where you will also find our Consumer Duty Podcast series
- **Read:** FCA Final Rules and Guidance – a new consumer duty
- **Watch:** The Consumer Duty: the Final Rules – your implementation journey begins
- **Watch:** Our Consumer Duty webinar – Retail, challengers and payments
- **Watch:** Our Consumer Duty webinar: Wholesale broker dealers, Investment banks, Financial intermediaries
- **Watch:** The Consumer Duty: Scoping and setting up implementation for success
- **Watch:** The FCA's Consumer Duty – In conversation with Ian Searle, FCA Head of Consumer Policy & Outcomes

Risk management: regulatory response to market disruption

Shifting macroeconomic sands

In the UK and many major economies, inflation is elevated, assets are being repriced, interest rates are rising quickly and real economic conditions may now be deteriorating.

This is a recipe apt to crystallise once-latent risks are exacerbated by leverage (especially synthetic or hidden leverage) and/or concentration. This in turn will prompt more regulatory focus on risk management – including in the supervisory and enforcement contexts.

Prudent firms now will review and strengthen their risk management measures to prepare for heightened regulatory engagement and position themselves well for upcoming crises.

Regulations might not change immediately, but regulators are changing how they use them

We haven't yet seen moves to change regulation (with three notable exceptions: calls to strengthen the regulation of cryptoasset service providers, the recent PRA supervisory statement 2/21 on operational risk and consultation paper 12/22 on risks from contingent leverage). This makes sense: existing regulation is principles-based and high-level, requiring robust governance including effective processes to identify, manage, monitor and report risks, adequate risk assessment and management policies and procedures, and risk tolerance and mitigation strategy setting. It's still worth revisiting these principles in your preparation for the next market disruption.

What's more noteworthy is UK regulators' real-time adjustments – which will continue into 2023 – to their supervisory and enforcement approaches in response to emerging and anticipated risks.

Reactive responses

UK regulators will respond to specific risks as they crystallise. Whilst those risks are as yet unclear, the regulatory responses will likely resemble recent examples, for example:

> Responding to the Archegos collapse, the PRA and FCA commenced a supervisory review of global equity finance businesses, asking each recipient firm to systematically review their risk management practices and controls and report findings to the PRA and FCA together with detailed remediation plans. We understand that there are ongoing investigations into specific impacted firms.

> Responding to the UK pensions LDI strategy crisis in the context of gilt market liquidity issues, the BoE backstopped gilt markets and UK regulators now are evaluating regulatory measures to mitigate future risk:
   > They intend to impose collateral requirements.
   > Safeguards against excessive leverage are firmly on the agenda.
   > They are also considering fund structures, resolution regimes, regulatory reporting (specifically on leverage, liquidity and buffers), governance and decision-making at speed especially within smaller market participants, funding and hedging strategies, operational resilience, and stress/failure testing.

> Responding to perceived shortcomings in regulatory reporting, the PRA commissioned a series of Skilled Person reports, sent a Dear CEO letter to banks and building societies with its findings and expectations for firms to conduct remediation, and will continue to focus on this area in 2022-2023. It has also recently fined Citigroup and Standard Chartered Bank for regulatory reporting issues.

> In the unregulated space, the FTX collapse has prompted calls for tighter regulation including to segregate different functions (eg deposit-taking and lending, exchange, and clearing), introduce collateral requirements and implement client asset safeguarding measures, guided by the principle (regardless of the technology underlying a product or service) of "same risk, same regulatory outcome".

Regulators have responded also to the crystallisation of firm-specific risks, for example the PRA's Goldman Sachs fine for risk management issues related to 1MDB, Metro Bank fine for risk weighting issues and MS Amlin fine for risk management issues coinciding with poor performance including driven by high levels of net catastrophe losses.

Proactive responses

UK regulators will proactively identify risks and seek to address them to the extent falling within their respective objectives. For the PRA, this is the safety and soundness of firms (and the PRA notably identifies governance and risk management

Further resources

Read: Well, stablecoin (prudential) regulation is definitely coming now (May 2022)

Read: PRA Business Plan 2022/23: what's on the horizon? (Apr 2022)

Explore: Culture, Governance and Accountability at Linklaters as a focus area in its latest business plan). For the FCA, this is market integrity and orderliness, as well as consumer protection to the extent that risk management impacts on consumer outcomes.

In 2023 both regulators will continue to conduct thematic work, supervisory engagement and targeted enforcement to address the risks they identify.

And they will continue to communicate their expectations in guidance and public statements. Most recently these have included the PRA and FCA joint letter commencing a supervisory review of global equity finance businesses, the PRA's latest business plan, and PRA Executive Director of Financial Stability Strategy and Risk Sarah Breeden's November 2022 speech on risks from leverage.

Regulatory expectations: key themes

Key themes can be distilled from these recent communications. These themes will recur in regulatory responses in 2023 and beyond. Firms would do well to address them in their attempts to mitigate future regulatory risk.

- Data.
  - Risk management relies on collection and production of accurate information and its exchange and escalation where actual or potential issues are detected.
  - Within firms, it is important to ensure input data of sufficient quality, that actionable management information is generated, and that governance exists to action information effectively.
  - Between firms and on a sector-wide basis, regulators will work with firms to improve exchange of useful information about credit risk and counterparty risk especially where leverage and/or concentration is present.
  - Accurate, complete and timely regulatory reporting is seen as key to effective prudential supervision. Failure to achieve this will continue to be a focus of enforcement action.
- Business strategy and organisation.
  - Regulators will expect businesses to set coherent business strategies and subject them to rigorous assessment and challenge by senior management, and adequately to support revenue objectives and new businesses with investment in risk management resource and infrastructure.
  - Firms' risk assessments should address each of the key financial risks including market risk, credit risk, counterparty credit risk and interest rate risk. They should also address operational and conduct risk.
  - It is especially important for firms to attend to this as they enter (or acquire) new businesses: difficulties can arise where risk management arrangements do not evolve with the business or with external developments.
- Financial risk management controls and governance.
  - Documentation standards should be strengthened, and contracts should give firms sufficient options to respond immediately upon identifying counterparty liquidity and credit concerns.
  - Margining approaches should be set with each counterparty's risk profile in mind and made sensitive to concentration and illiquidity risks.
  - Firms should have processes for ongoing due diligence of their counterparties including a holistic assessment of each counterparty's overall leverage.
  - Controls should account for market dynamics and structural shifts that may change correlations and norms, and for the assessment of wrong way risk (where the value of collateral held as security falls in the very situation where the counterparty defaults, including where attempts to realise collateral might add to negative price dynamics).
  - It is worth harvesting lessons from recent enforcement action involving findings of governance deficiencies albeit outside the risk management context, for example the FCA's UBS and Goldman Sachs transaction reporting fines and the PRA's Standard Chartered regulatory reporting fine.
- Governance.
  - Firms should review their three lines of defence arrangements and consider establishing independent risk management groups.
  - Risk management tools should be calibrated appropriately, including to function adequately in a crisis. Formal counterparty risk limits, exposure monitoring and stress tests should be critically evaluated for real-world effectiveness and data quality issues and should account for tail risks.
  - Governance arrangements in general should be made with transparency in mind, to accommodate and encourage challenge, to give support to each function or role, to provide for clear escalation paths, and incorporate robust record-keeping.
- Senior accountability and prudent incentive setting.
  - The regulators see clear links between senior accountability and improved risk management and will leverage the SMCR in this context.
  - Remuneration arrangements should be calibrated to incentivise prudent risk management.
- Culture.
  - The regulators see culture as foundational to the success of any governance arrangement.
  - In particular, the PRA and FCA view diversity and inclusion as an important mitigant to group think and a way to help foster constructive challenge and debate within organisations.
- Effective regulatory intervention.
  - In respect of regulation and supervision, focus areas may include excessive leverage, transparency and predictability of margin calls, stress testing, enhancing liquidity preparedness, and evaluating the responsiveness of cleared and uncleared margin models.
  - In market interventions, central banks will weigh their role as a backstop liquidity provider against the potential to distort market mechanisms.

Financial Regulation Legal Outlook 2023

Fintech and Payments

Fintech and Payments

What's coming up for Fintech and Payments: key events and publications for 2023

UK

EARLY 2023

Fintech
Early 2023 - BoE to consult on regulatory framework on systemic payment systems and services

JANUARY

Payments
Jan - 14 directed firms are required to implement the PSR's card-acquiring market remedy around POS terminal contracts

FEBRUARY

Fintech
10 Feb - Close of UK regulators discussion paper on the use of artificial intelligence and machine learning

Q2 2023

Fintech
Q2 2023 - FCA and BoE to create a Financial Market Infrastructure Sandbox

Operational Resilience
Q2 2023 - UK regulators expect to consult on operational resilience critical third parties to the UK financial sector and on operational incident reporting requirements

Payments
Spring - FSM Bill to be enacted; HMT to start making commencement regulations

JULY

Payments
Summer - PSR to publish data on how well firms are protecting customers from APP scams

Payments
Jul - 14 of the most significant providers of card-acquiring services to give effect to remedies on summary boxes and trigger messages

SEPTEMBER

Payments
Sep - Bank of England will introduce the new RTSG2 core leger and settlement engine

Fintech
1 Sep - UK version of travel rule starts to apply

Q3-4 2023

Fintech
Q3 - FCA to publish feedback statement on BigTech following discussion paper

OCTOBER

Payments
31 Oct - Deadline for PSR 'Group 1' firms to implement confirmation of payee

EARLY 2023 | JANUARY | FEBRUARY | MARCH | APRIL | Q2 2023 | MAY | JUNE | JULY | AUGUST | SEPTEMBER | Q3-4 2023 | OCTOBER | NOVEMBER | DECEMBER

EU

EARLY 2023

Operational Resilience
Q1 2023 - DORA expected to enter into force (with a two year implementation period)

FEBRUARY

Fintech
13-16 Feb - European Parliament to consider proposed MiCA and transfers of funds and certain cryptoassets

MARCH

Payments
20 Mar - ECB to launch new real-time gross settlement system and T2 (rescheduled from 21 Nov 2022)

Fintech
23 Mar - Majority of DLT Pilot Regime Regulation starts to apply

Fintech
By 23 Mar - ESMA to finalise guidelines on standard forms and templates to apply for permission to operate a DLT market infrastructure

Q2 2023

Fintech
Spring - MiCAR expected to enter into force (but not apply until 2024)

Fintech
Spring Commission due to release its proposal for an open finance framework

Payments
Q2 2023 - Commission to conclude PSD2 review and submit proposal for any legislative change

JULY

Fintech
Mid-2023 - FSB expects to finalise recommendations for a framework for international regulation of cryptoasset activities

Q3-4 2023

Operational Resilience
Q3 - ESAs expected to produce Level 2 technical standards on DORA

OCTOBER

Payments
Oct - ECB governing council to decide whether to launch realisation phase for development of a digital euro

NOVEMBER

Fintech
10 Nov - Deadline by which EU crowdfunding service providers must be authorised under the Crowdfunding Regulation

+ Click to read more | Fintech | Payments | Operational Resilience

Crypto

The regulation of crypto enters a new phase. Having already applied anti-money laundering rules to crypto exchanges and custodian wallet providers, the UK and EU are now moving towards more comprehensive regulatory regimes for crypto issuers and service providers. While regulation is increasingly seen as a white knight to help stabilise confidence in the sector, market participants must prepare to meet higher compliance standards while navigating choppy market conditions.

Both the UK and EU are prioritising the regulation of stablecoins. These are cryptoassets which promise to maintain a stable value. As part of its “staged and proportionate” approach to regulating cryptoassets, the UK government is starting with stablecoins used as a means of payment. The mechanism is the Financial Services and Markets Bill which allows the Treasury to develop a regulatory regime for **digital settlement assets**, broadly digital representations of value or rights that can be used for the settlement of payment obligations. Although it is not addressed in the Bill, the government has previously suggested that cryptoassets which stabilise their value using algorithms would, at least initially, not be caught by the regime. However, it remains to be seen whether this continues to be the policy following more recent developments in crypto markets.

The government intends to adapt electronic money and payments legislation to accommodate digital settlement assets. This means that a regulatory licence will be needed to undertake several activities relating to these assets in the UK, including issuance, value stabilisation and reserve management, custody and exchange services. Authorised firms would have to then meet prudential standards and comply with rules relating to, for example, safeguarding, risk management, governance, systems and controls, record-keeping and operational resilience. The Bank of England will also be tasked with supervising potentially systemic digital settlement assets. Some form of transition period is likely to give businesses handling stablecoins time to prepare but the precise timetable is unknown.

The next step for the UK is to consider bringing **wider forms of cryptoasset activity** within the scope of regulation. The Financial Services and Markets Bill allows the Treasury extensive flexibility in how this future crypto regulation may be made. It amends existing legislation to clarify that the Treasury can use its powers to specify regulated activities relating to cryptoassets, which is broadly defined. The new designated activities regime may also be applied to cryptoassets if the Treasury chooses. Many market participants hope that the Treasury will adopt a flexible approach to creating regulation which not only protects consumers but also takes into account the unique features of cryptoasset technology.

UK cryptoasset exchanges and custodian wallet providers must register with the FCA so the regulator can supervise their compliance with anti-money laundering rules. These rules are set to be updated next year. The Financial Action Task Force recommends that personal information about the originator and beneficiary should accompany transfers of cryptoassets. The UK’s version of this FATF rule, known as the **travel rule**, will be added to the Money Laundering Regulations and start to apply from 1 September 2023. It means that FCA-registered cryptoasset exchanges and custodian wallet providers have until then to put in place systems allowing them to share the relevant information about their customers.

FCA-registered cryptoasset businesses should also remember that the Money Laundering Regulations now include a **change in control** regime. This allows the FCA to object to an acquisition or increase in control of a registered cryptoasset business before the acquisition takes place. Controllers and prospective controllers should factor appropriate time into any changes of ownership relating to cryptoasset exchanges and custodian wallet providers to allow the FCA to complete its assessment of their fitness and propriety.

Crypto marketing will be brought into the UK **financial promotions** regime. The Financial Services and Markets Bill clarifies that the Treasury’s existing powers allow it to extend the general restriction on financial promotions to cryptoassets. The UK government has confirmed that it intends to apply the restriction to a wide range of “qualifying cryptoassets” (to be defined). The changes can be made via secondary legislation. A six-month transition period will give firms time to prepare. The FCA has already indicated that it plans to treat cryptoassets as high-risk investments. This will likely inhibit most

Further resources

- **Explore:** FintechLinks blogposts
- **Explore:** Tech insights
- **Explore:** Payments podcasts
- **Explore:** Monthly fintech and payments regulation newsletter
- **Explore:** A timeline of UK cryptoasset regulation
- **Explore:** Here we go again… EBA plots reform of European payments rules
- **Explore:** UK plans for regulating buy-now, pay-later
- **Read:** How AI in financial services is regulated in the UK
- **Explore:** Contemplating the metaverse
- **Read:** Financial promotions gateway to pose problems for crypto firms

crypto marketing in the UK. The FCA will finalise its rules for cryptoasset promotions once the relevant legislation to bring qualifying cryptoassets within the financial promotions regime has been made. Until then, the Advertising Standards Authority continues to monitor crypto ads.

The UK's approach to regulating cryptoassets will inevitably be compared to the EU's Markets in Cryptoassets Regulation (MiCA). Nearly two and a half years after it was first published, MiCA is set to enter into force in spring 2023. Like the UK, the rules relating to stablecoins are prioritised and will start to apply in spring 2024. Other aspects of MiCA will start to apply in autumn 2024 although transitional measures should allow implementation to be delayed further. Cryptoasset businesses which want to continue to access the EU market should start engaging with the legislation to understand what they need to do and by when.

When it comes to stablecoins, MiCA distinguishes between **e-money tokens**, which are pegged to a single fiat currency, and **asset-referenced tokens**, which are pegged to more than one currency or other assets. Issuers of EMTs and ARTs must provide a right of redemption to holders which can be exercised at any time. Volume caps for ARTs and some EMTs used as means of exchange may impact some of the most-prominent global stablecoins.

MiCA sets a regulatory regime for **cryptoasset service providers**. Under MiCA, crypto custodians, exchanges, advisers and portfolio managers are among those which will need to seek authorisation when offering their services in the EU. MiCA-authorised cryptoasset service providers must comply with rules on, for example, conduct of business, governance, outsourcing and safeguarding of cryptoassets and private keys. The rules are not expected to start applying until autumn 2024 and providers which already have a local licence from an EU regulator may be able to benefit from transitional measures. MiCA-authorised cryptoasset service providers will also need to comply with the EU's digital operational resilience act, known as DORA, once it starts to apply in late 2024.

Cryptoasset firms will need to keep a close eye on the development of **technical standards**. MiCA tasks the European Supervisory Authorities with setting more detailed rules in several important areas. For example, the European Securities and Markets Authority must by spring 2024 consider the energy use of different types of consensus mechanism used to validate cryptoasset transactions to supplement the ESG disclosure requirements in MiCA. The volume of technical standards due in the next 12-18 months will put a lot of pressure on resources at the European Supervisory Authorities. Late or last minute publications of significant rules will lead to calls for a delay to aspects of MiCA starting to apply or some form of regulatory forbearance to allow the industry more time to prepare for full compliance.

There will also be areas of legal uncertainty for which the European Supervisory Authorities have not been instructed to develop further regulations. **Q&A and guidelines** may be developed to clarify the authorities' views in these areas and to support harmonised supervision of MiCA across the EU. Unfortunately, this guidance is likely to appear late in the day, including after the relevant provisions of MiCA have come into effect, by which point many firms will have had to have taken a view on how the rules apply to them.

Given the fast-moving pace of development in crypto markets, it is not surprising that MiCA sows the seeds for its replacement. Among other issues, the European Commission is required to assess the development of **DeFi** and NFTs and report on whether their regulatory treatment is appropriate. These matters are likely to be picked up in a future MiCA 2.0.

For now, MiCA states that its rules do not apply to **non-fungible tokens** (NFTs). Recitals, however, complicate matters by qualifying what should be considered "non-fungible". For example, fractional entitlements and NFTs in a large series or collection could be fungible and so potentially within the scope of MiCA. It is also possible that individual EU Member States could develop national regimes applying to NFTs.

MiCA is not the only significant legislative change for crypto markets in the EU. The recast Funds Transfer Regulation will impose the FATF **travel rule** on MiCA authorised cryptoasset service providers. The rule is aligned to start applying with MiCA and will require information to be shared about the parties to cryptoasset transfers. Separate changes to the AML Directive will be negotiated which will likely ban EU regulated firms (including MiCA authorised firms) from using wallets designed to keep account holders anonymous. Cryptoasset firms will also need to engage with a new European Supervisory Authority in the future. AMLA will be tasked with overseeing AML compliance across EU financial institutions, including MiCA authorised firms.

Other jurisdictions are expected to follow the EU's footsteps by regulating cryptoassets. The Financial Stability Board aims to support **international coordination** between these emerging regimes and is set to report to the G20 in summer 2023. It will recommend empowering national regulators to oversee cryptoasset activities and markets. According to the FSB, crypto issuers and service providers should be brought within the scope of the regulatory perimeter and rules should be applied to them proportionately to make sure, for example, they apply effective governance and risk management frameworks and comply with disclosure requirements.

The FSB's recommendations do not directly impact businesses, but they will become the international standard that policymakers will seek to meet. For example, the FSB advises that regulation should be used to address the risks arising from multiple functions being combined within a single service provider. Expect policymakers to follow this recommendation in the wake of the failure of FTX. In time, this could lead to structural segregation drawing brighter lines between trading platforms and other services such as lending and derivative products.

The FSB also plans to update its recommendations for the regulation of **global stablecoin arrangements**. The collapse of Luna/Terra has drawn attention to stablisation methods and the redemption rights of stablecoin holders. According to the FSB, stablecoins should not rely on arbitrage activities or algorithms to maintain a stable value. Implementing this recommendation in national law would throw down the gauntlet because most existing stablecoins would not meet the revised FSB standards.

Payments

Interbank payments are among the alternatives to cards starting to gain traction with consumers and upcoming regulatory changes aim to facilitate this growth. Payments firms are being held to higher standards and the regulatory perimeter may be extended to accommodate new players in payment chains. As plans are put place to protect cash infrastructure and access to cash, central banks are pressing ahead with issuing their own digital currencies.

For UK payment institutions and e-money issuers, the most significant regulatory change on the horizon is the **consumer duty**. The duty, which obliges firms to deliver good outcomes for retail customers, starts to apply from 31 July 2023. Firms can expect the FCA to leverage the duty to reiterate familiar supervisory priorities for payment service providers. For example, the FCA wants to see evidence that firms have appropriate safeguarding arrangements, hold adequate financial resources and give clear customer communications.

Payments firms must continue to build their **operational resilience**. Under the FCA's rules, self-assessment documentation should be kept up to date as firms develop the sophistication of their mapping and scenario testing. Vulnerabilities should be addressed ahead of the March 2025 deadline for remaining within impact tolerances in the event of severe but plausible disruption.

Expect the FCA to call yet again for the **Senior Managers and Certification Regime** to be applied to payment institutions and e-money issuers. The SMCR would mean, for example, that all employees would need to be trained on, and comply with, basic standards of conduct. Legislation would be required and, so far, the Treasury has not publicly indicated that further extension of the SMCR is on its agenda. The Treasury has said that it will apply the SMCR to recognised payment systems but has not provided for this under the Financial Services and Markets Bill. Instead, it plans to bring forward separate legislation to apply the SMCR to payment systems following the completion of its payments landscape review.

Two market reviews are high on the agenda of the **Payment Systems Regulator**. One will explore card scheme and processing fees while the other focuses on interchange fees between the UK and EU. The PSR is also overseeing the extension of the Confirmation of Payee service, initially to a group of 32 payment service providers by 31 October 2023. Mandatory reimbursement of innocent victims of authorised push payment fraud in Faster Payments is also on the cards thanks to changes under the Financial Services and Markets Bill.

Following its **payments landscape review**, the Treasury has indicated it wants to bring "systemically important firms in payments chains" under the supervision of the Bank of England. It remains to be seen how widely the net is cast but it could capture, for example, currently unregulated tech companies which have become integral to making payment transactions happen.

Two new regimes aim to shore up **access to cash** and **wholesale cash distribution**. The Financial Services and Markets Bill appoints the FCA as the lead regulator for access to cash. The Treasury will be able to designate the largest banks and building societies to be subject to FCA oversight to ensure continued cash withdrawal and deposit services across the UK. The Bill also enables the Bank of England to regulate entities that provide wholesale cash activities and provides for the prudential regulation of any systemic entity in the market should one arise in the future.

The Bank of England and Treasury are expected to confirm that they will move to a development phase for issuing a **central bank digital currency**, or CBDC. A consultative report is due around the end of 2022 which will set out their proposed next steps. The Bank of England has hinted that any future digitally-native pound should be designed so as to capitalise on potential technology benefits, such as programmability.

In the EU, all eyes are on the European Commission to see what legislative proposals emanate from its delayed **PSD2 review**. The European Banking Authority has written a long shopping list of amendments to EU payments legislation to fix what it calls a significant number of issues. These range from structural changes (such as merging e-money and payments rules and recalibrating the list of regulated payment activities) through to relatively minor tweaks. It is unlikely that all these suggestions will be picked up. The Commission may prefer to focus its attention on a handful of priority areas such as consumer protection, access to payment systems and open finance. Any legislative proposals will set the wheels in motion for PSD3.

As well as promising the PSD2 review, the Commission's 2020 retail payment strategy highlighted the need for an EU-wide **instant payments** scheme. The Commission has proposed legislation to help bring this to life. The draft law aims to make instant euro payments available to all citizens and businesses holding a bank account in the EU by amending the 2012 Regulation on the Single Euro Payments Regulation (SEPA). The text will be scrutinised by the European Parliament and Council over the course of 2023.

Reform of the EU's **digital identity** framework is another area for payments firms to watch. Adopted in 2014, the eIDAS regulation provides for cross-border electronic identification and authentication within the EU. Negotiations on an update to the eIDAS framework are due to start in early 2023. Under the proposed changes, EU Member States would offer a European digital identity wallet which would link EU citizens' national digital identities with other IDs such as driving licences. This could have a significant impact for payment service providers, not only as it may affect compliance with strong customer authentication standards but also because it could open up new opportunities for customer onboarding processes.

The European Central Bank has recently updated its oversight framework for electronic payment instruments, schemes and arrangements, known as the PISA framework. The framework now extends to all electronic payment instruments including payment cards, credit transfers, direct debits, e-money transfers and digital payment tokens. Any new schemes or arrangements which are informed that they fall within the scope of the PISA framework must comply with its requirements within one year.

The Commission will put forward legislation for a **digital euro** in early 2023. This will outline principles for the digital euro and clarify that it can be used as the single currency alongside banknotes and coins. The definition of funds under PSD2 may also be adjusted. The most contentious parts of the draft law are likely to relate to privacy and data protection. Meanwhile, the ECB is expected to move from investigating to developing the digital euro in autumn 2023.

Artificial Intelligence

As the use of AI in financial services grows, so too will calls for greater clarity around how firms should be implementing the technology.

The UK is changing its attitude to AI regulation. Previously, the government had advocated a sector-led approach, allowing individual regulators and industries to respond to the risks as they identify them. Looking ahead, expect to hear more about **cross-sectoral principles** for regulating AI. These principles are intended to steer regulators towards providing more "light touch" guidance for the businesses they oversee rather than detailed rules.

In the financial services sector, the Bank of England, PRA and FCA are using a **discussion paper** to seek feedback on the challenges associated with the use of AI and machine learning. After the discussion period closes in February 2023, the regulators will look to clarify how the current regulatory framework applies to AI, especially where it is perceived as a barrier to safe innovation.

The European Parliament, Council and Commission are due to start negotiations on the **EU AI Act** by mid-April 2023. The draft law suggests that AI which is used to assess an individual's creditworthiness or credit score would be deemed high risk. This would then have implications for the firms that use the AI for that purpose. For example, they would need to have specific risk and quality management systems in place and ensure human oversight by suitably trained individuals. A separate draft directive on AI liability suggests that those responsible for high-risk AI should on request disclose information on the system's training datasets, quality management and technical documentation.

Further resources

Explore: How AI in financial services is regulated in the UK

Other key developments

Big Tech in finance

Before summer 2023 the FCA will share feedback from its discussion paper on Big Tech's entry and expansion into retail financial services. It remains to be seen whether the FCA will follow this up with any policy or rule changes. Any intervention would need to be carefully calibrated to reap the benefits of Big Tech's disruptive role in the short term but ward against potential abuse of market power in the longer term.

BNPL

The UK government is pressing ahead with its plans to bring unregulated BNPL products within the regulatory perimeter. The changes to the consumer credit legislation will be finalised by summer 2023 and the FCA will consult on what the detailed rules for BNPL will look like. Before the law changes, the FCA is continuing to scrutinise whether BNPL providers comply with the financial promotions regime when they advertise their products. Meanwhile discussions continue on changing the EU's consumer credit regime which is expected to bring some BNPL products into its scope.

DLT sandboxes

The Financial Services and Markets Bill sets up a framework for financial market infrastructure to explore using distributed ledger technology. Given the potential of DLT in financial markets, this so-called FMI sandbox is going to be prioritised so that it is live by the end of 2023. Applications open for the EU's equivalent programme – the DLT pilot regime – in March 2023.

Open finance

Seen as the natural next step after open banking, open finance seeks to give consumers easier access to their data for a broader range of financial products. Following its 2022 OpenFin policy sprint and earlier call for input, the FCA is working out how to support industry-led efforts to develop common standards, such as via the Open Finance Association. In the EU the Commission is due to release its proposal for an open finance framework in spring 2023.

Metaverse

The metaverse could prove to be the next iteration of the internet. For financial services, there are commercial opportunities if it becomes a place where more people interact and transact virtually. Legal and regulatory risks will also need to be managed as firms embed themselves inside this new digital reality.

Further resources

Explore: Contemplating the metaverse

Financial Regulation Legal Outlook 2023

Asset Management

Asset Management

What's coming up for Asset Managers: key events and publications for 2023

UK

EARLY 2023

Future UK Regulatory
2023 - UK regulators expect to consult on operational resilience critical third parties to the UK financial sector and on operational incident reporting requirements

Prudential
2023 - First disclosures under IFPR will be due

Funds
Early 2023 - FCA expects to publish final rules on broadening retail access to the LTAF

MiFID II
Early 2023 - FCA is expected to publish policy statements on changes to equity transparency requirements and trading venue perimeter

FEBRUARY

Financial Promotions
1 Feb - All other new FCA rules on strengthening financial promotion requirements for high-risk investments take effect

Consumers
1 Feb - All other new FCA rules on strengthening financial promotion requirements for high-risk investments start to apply

Consumers
28 Feb - Deadline for principal firms to submit s165 appointed representatives request to the FCA

APRIL

Consumers
Apr - FCA expects to deliver its consumer investment strategy and final rules on its new streamlined investment advice regime

Consumers
30 Apr - Manufacturers should aim to complete all the reviews necessary to meet the four outcome rules under the Consumer Duty for their existing open products and services

Q2 2023

Future UK Regulatory
Spring - Financial Services and Markets Bill 2022-23 (FSMB) expected to be enacted

Consumers
Spring - CMA to provide an update on its ongoing investigation into alleged anti-competitive arrangements in the financial services sector

MiFID II
H1 2023 - FCA to consult on equity and non-equity transparency regimes and on what a consolidated tape might look like in the UK

JUNE

ESG
30 Jun - First annual reports on TCFD compliance due from large asset managers and owners

JULY

Consumers
31 Jul - Consumer Duty rules start for new and existing products or services that are open to sale or renewal

AUGUST

Consumers
31 Aug - Pension providers to implement pension dashboard rules

NOVEMBER

Consumers
30 Nov - Firms first annual reviews of Appointed Representatives assessments due

DECEMBER

Future UK Regulatory
End of 2023 - Close of UK's temporary permissions regime

Consumers
8 Dec - Deadline for principals to have carried out their first annual review of Appointed Representatives

EARLY 2023 | JANUARY | FEBRUARY | MARCH | APRIL | Q2 2023 | MAY | JUNE | JULY | AUGUST | SEPTEMBER | Q3-4 2023 | OCTOBER | NOVEMBER | DECEMBER

EU

EARLY 2023

Funds
Q1 2023 - ESMA to publish final report on the information and templates for cross-border marketing and management notifications under UCITS and AIFMD

MiFID II
Q1 2023 - ESMA expects to publish final report on MiFID II product governance guidelines

MiFID II
Q1 - ESMA to publish final guidance in the form on an opinion on market outages and its final opinion on the trading venue perimeter

Consumers
Early 2023 - Commission expected to adopt its strategy for retail investors

Prudential/ESG
During 2023 - First ESG disclosures under IFR will be due

JANUARY

Funds
1 Jan - PRIIPs KID exemption for UCITS and PRIIPs reform come into effect

ESG
1 Jan - Disclosure requirements in the Taxonomy Regulation relating to remaining environmental objectives start to apply

ESG
1 Jan - Delayed date of application of SFDR RTS

ESG
1 Jan - Complementary Climate Delegated Act covering gas and nuclear activities start to apply

FEBRUARY

MiFID II
Jan/Feb - European Parliament expected to adopt final report on amendments to EU MiFID Review

MARCH

MiFID II
Mar - ESMA's guidelines on MiFID II suitability requirements are expected to apply

ESG
Mar - TNFD aims to publish final draft version of its disclosure framework

Q2 2023

ESG
Q2/Q3 - ESMA expects to publish final guidelines on funds' names with ESG or sustainability-related terms

MiFID II
Q2 - Trilogues are expected to commence on MiFID review

JUNE

ESG
17 May - ESAs due to provide progress reports to Commission on greenwashing risks and supervision of sustainable finance

ESG
30 Jun - Financial market participants due to make first principal adverse impacts (PAI) statement under SFDR RTS

JULY

MiFID II
Q3 - Political agreement is expected to be reached on EU MiFID Review

ESG
Q3 - ESAs expected to respond to Commission with amendments to SFDR RTS relating to PAI indicators (original deadline of 28 April is delayed by six months)

SEPTEMBER

ESG
Sep - Task Force on Nature-related Financial Disclosures (TNFD) expects to publish final version of its disclosure framework

NOVEMBER

ESG
Nov - ESAs due to report to Commission on amending the SFDR RTS to reflect PAI indicators and enhanced transparency

DECEMBER

MiFID II
End of 2023 - ESMA expects to publish report on rules for passporting for investment firms

ESG
31 Dec - Commission expected to publish an assessment of impact of EU sustainable finance agenda

Click to read more

Consumers | MiFID II | ESG | Funds | Future UK Regulatory | Prudential | Financial Promotions

ESG (Outlook)

The driver for policymakers, and increasingly for supervisors, continues to be greenwashing – both in the EU, the UK and beyond. In 2023 we can expect a tightening of the concepts and terms used, with definitions of "greenwashing" being developed. This will sit alongside increasingly granular expectations around how climate and environmental financial risks are identified and monitored. Expectations for detail indicate that blaming the data may cease to be an acceptable excuse.

Greenwashing risk can take many forms, and there are increasing avenues of liability as new regulation emerges, regulators flex their muscles, new regulators (recall recent enforcement action by the UK's Advertising Standards Authority) use their powers and claimants bring more cases: this is a rapidly evolving landscape that needs to be kept under review. This review is necessary both internally – to keep track of greenwashing risk within the evolving context of the business – and externally – to keep a close eye on how policy developments impact that "greenwashing" concept.

Firms will need to think carefully about the steps they can take now to identify potential areas across their businesses for greenwashing, and how they can monitor, mitigate and ultimately try to prevent greenwashing. This includes developing a credible and consistent narrative around what greenwashing means, implementing robust internal procedures for scrutiny and developing disclosures in line with emerging UK and international standards.

Asset managers have grappled with the EU's disclosure framework since 2021, although the most granular product disclosure rules are only now coming into effect from 1 January 2023. But this does not represent the end: further developments are coming in 2023 as the EU continues to refine its approach.

Firms will also be focused on the FCA's developing disclosure and labelling regime, as well as managing the differences between the UK, the EU and other relevant regional rule-sets. The core elements of the UK's proposals – labelling and classification, disclosure and naming and marketing rules – will apply to asset managers initially, but with the expectation that this could expand to FCA-regulated asset owners in respect of their investment products. Targeted rules for the distributors of investment products to retail investors in the UK have also been proposed.

On greenwashing, the FCA is making its expectations concrete, with **all regulated firms** needing to take note of its proposed "anti-greenwashing" rule. This will apply to all firms and could be in force as early as June 2023. This chimes with work undertaken in the EU to come to a definition of greenwashing, and on which the European Supervisory Authorities have asked the industry for feedback, data and examples.

Whilst disclosure has been the focus of the asset management industry, prudential reform related to climate and environmental financial risk management continues to be a key concern of the banking sector, with the PRA and the European institutions, notably the ECB and the EBA, setting their expectations for resilience in this space.

Further resources

Explore: Our Sustainable Futures blog for updates on all the ESG topics mentioned in this report

Read: Sustainable Finance Sources: Survival Guide

Explore: Our COP 27 microsite

Watch: COP27 – What does the outcome mean for businesses around the world?

Coming soon: for 2023 we will be launching our global Sustainable Finance Tracker. Email Victoria Hickman to find out more about it

ESG (UK Developments)

UK Government's Net Zero Review

The Government announced a "rapid" independent review of how best to meet the UK's legally binding climate target of net zero by 2050 in a way that grows the economy and does not place undue burdens on businesses or consumers. The review has been commissioned by the Department for Business, Energy & Industrial Strategy.

The call for evidence, published on 29 September, includes questions such as:

> what challenges and obstacles have you identified to decarbonisation;

> what opportunities are there for new/amended measures to stimulate or facilitate the transition to net zero in a way that is pro-growth and/or pro-business; and

> what more could the government do to support businesses and consumers to decarbonise?

The review team had been asked to report back to the Government by the end of 2022 and despite recent political upheaval we understand that a report is still expected before the end of the year.

UK SDR

Building on its November 2021 discussion paper, the FCA has finally published its long-awaited consultation paper CP22/20 on the SDR regime and investment labels. Applicable to financial services firms as well as other corporates, the primary focus is to address "greenwashing" in financial products and provide greater clarity to investors as to how sustainable the financial products they invest in really are.

There are some important differences between the EU and proposed UK regimes:

> Unlike the EU SFDR (envisaged as a disclosure-based regime but inadvertently used as a product classification regime), the FCA's SDR proposals are explicitly envisaged as a labelling regime. The use of these labels will be voluntary (but any products that do not qualify for these labels will face limitations in terms of their marketing and naming).

> To avoid the requirements becoming too restrictive at this stage, the FCA has not embedded "do no significant harm" or PAI requirements within the eligibility criteria (albeit considerations of harm do appear in some of the example products that the FCA suggest would meet its labels).

> The FCA's proposals go further than the EU's SFDR by introducing specific obligations for distributors of investment products.

> Notably the proposals do not place specific obligations on financial advisers (who would nevertheless be caught as distributors) but we expect a separate FCA consultation on specific rules for advisers.

Notably the FCA proposes putting in place a **general anti greenwashing rule**, applicable to all FCA regulated firms (not just asset managers, unlike the focus of the SFDR). This cornerstone proposal will require all FCA regulated firms to revisit their approach to ESG and sustainability across all product types (not just investment products in scope of the SDR) and disclosures.

The FCA's consultation closes on 25 January 2023. The proposal is for the anti-greenwashing rule to come into effect as soon as it publishes the policy statement on these reforms (expected 30 June 2023). All other reforms will have at least a one-year implementation period, taking effect from 30 June 2024 or thereafter.

Mandatory UK TCFD reporting requirements

TCFD reporting is already mandatory (on a "comply or explain" basis) for premium and standard listed companies in the UK under changes made by the FCA to the Listing Rules.

It is also mandatory for large asset managers and asset owners, for whom the obligation commenced at the beginning of 2022 with first reports due by 30 June 2023. The FCA's rules for asset managers and asset owners are contained in a new "ESG" sourcebook to the FCA Handbook. In 2023, the remaining UK asset managers and asset owners (excluding those below a de minimis threshold) will be brought within scope of the rules, with their first reports to follow by 30 June 2024.

In addition, changes have been made to the Companies Act 2006 and the LLP Act 2000 which require large UK private companies and LLPs to make TCFD climate-related disclosures in their annual reports for financial years starting on or after 6 April 2022. This obligation catches many financial services firms, including UK banks, who will need to make their first reports on this in 2023. The obligations are slightly lighter than the TCFD recommendations and are likely to require revision over time, particularly when ISSB standards become the prevailing standard adopted in the UK.

Further resources

Read: FCA outlines draft ESG disclosure rules for UK financial services

Watch: A look at the FCA's consultation on its Sustainability Disclosure Requirements

Watch: our webinar on greenwashing

Watch: our webinar on how to produce accurate and robust climate transition plans

Prudential risk management of climate and environment financial risk

In October 2022, the PRA issued a Dear CEO letter in which it reflected on progress against Supervisory Statement 3/19 (which dealt with supervisory expectations for firms' management of climate-related financial risks). Although not of direct relevance to the asset management sector (save where the asset manager is part of a PRA-regulated banking group), the observations and feedback are informative with regard to regulators' governance and risk management expectations.

The PRA observed areas of good and bad practice, focussing on:

> **Board oversight.** The PRA noted that for international firms, the boards would need oversight of climate-related metrics that are monitored across regions with management information was cascaded across relevant governance forums.

> **Responsible SMF.** The PRA noted that the majority of firms now include an allocated SMF with responsibility for the financial risks from climate change.

> **Risk Management.** The PRA criticised weaknesses in fully understanding counterparties' exposures or transition plans, and noted that many banks faced challenges in sourcing this information.

> **Disclosure.** The PRA observed that Pillar 3 disclosures were not being used as the primary means for firms to disclose their climate risks and queried whether this is appropriate.

Looking ahead

Green taxonomy

The Green Technical Advisory Group (GTAG) has published its first independent advice to the UK government on the design and implementation of a UK Green Taxonomy. However, consultation on the taxonomy has still not been launched (despite having been expected in Q1 2022). Indications from Treasury are that the UK's plans for its taxonomy are under review internally.

Investor stewardship

Investor stewardship remains a priority, and the UK Government plans to assess the progress of the pensions and investment sectors towards the investor stewardship objectives set out in the UK Stewardship Code and the Greening Finance Roadmap by the end of 2023.

Transition planning

At COP26 last year, the UK announced its intention to require disclosure of transition plans as a key tool in the UK's pledge to achieve net zero. Transition plan disclosure is recommended by TCFD, and forms part of the FCA's mandatory TCFD reporting requirements. It will also be required under the SDRs. This echoes a global push – transition plan disclosure will be required by ISSB disclosure standards (which the UK has said it plans to mirror) – as well as requirements emerging in the EU, for example under CSRD.

In 2022, the UK Government set up its Transition Plan Taskforce whose purpose is to devise the "gold standard" for transition plans. The Taskforce published its proposed "sector neutral" disclosure framework and guidance in November. The consultation closes in February 2023 and will be followed at some point in 2023 by sector specific disclosure frameworks including for the financial services.

ESG (EU Developments)

EU Taxonomy

Climate change adaption and mitigation: The Climate Delegated Act has applied since 1 January 2022. Against the backdrop of immense controversy, a complementary delegated act amending the Climate Delegated Act to include technical screening criteria for nuclear energy and natural gas activities will enter into force on 1 January 2023. Although the Commission is facing requests for internal review, and even legal challenge for the inclusion of these two activities in the taxonomy, the Complementary Delegated Act will remain legally valid until such time as the Commission or the CJEU decide to revoke it.

Remaining 4 environmental objectives: The PSF published its final recommendations in March 2022, but the Commission has yet to adopt its delegated act covering these remaining objectives. These rules had been expected in the "autumn" of 2022 in time for a 1 January 2023 application date but given the need to consult on any draft issued by the Commission, sights are now set on publication in 2023, with the rules applying thereafter.

SFDR the latest

The SFDR Level 2 requirements apply from 1 January 2023. Somewhat late in the day, given this impending deadline, ESMA published on 17 November an extensive Q&A primarily on the Level 2 rules but also impacting the Level 1 regulation and taxonomy. The Q&A is effective immediately and is applicable to all firms subject to SFDR, so firms will need to consider carefully whether, and how, their disclosures are impacted, and whether any changes are needed.

But with more to come, this is still not the finish line for SFDR:

- In September, the ESAs posed some quite fundamental questions on the interpretation of the SFDR, including around the definition of a "sustainable investment". The Commission's answers are still pending, although it has been indicated that these will not be received until after 1 January 2023. Market practice has already been established on many of the areas covered given Level 1 SFDR has been in force since 2021 and in preparation for the January 2023 application date. As such there is a concern that the Commission's responses may upend market practices.
- The Commission has updated the Level 2 rules to add disclosures to provide transparency about investments in taxonomy-aligned gas and nuclear economic activities. These amendments are currently with the European Parliament and Council and are expected to come into force in Q1 2023.
- Finally, the ESAs have been tasked with proposing amendments relating to PAI indicators and to the transparency of financial product disclosures. The number of technical components to this work, and the need for input from a range of expert bodies/agencies means that the original April 2023 deadline will be missed, and the ESA's response could be delayed by up to six months. This in turn will delay any Commission amendments to the rules.

From NFRD to CSRD

The European Parliament and Council have adopted the Corporate Sustainability Reporting Directive (CSRD), which will extend sustainability reporting requirements to 38,000 public and private sector companies. The CSRD replaces the Non-Financial Reporting Directive (NFRD), which was widely acknowledged to have been ineffectual in driving sustainability disclosures by corporates. It introduces more detailed reporting requirements on companies' impact on ESG standards, based on common criteria in line with the EU's climate goals. In scope organisations will be required to make their reports using a set of mandatory European sustainability reporting standards (ESRS) that are being developed by the European Financial Reporting Advisory Group (EFRAG) on behalf of the Commission. EFRAG submitted final drafts of the first ESRS to the Commission in November and these are expected to be adopted by June 2023.

The new CSRD rules are expected to apply between 2024 and 2028 (absent any further delay):

- From 1 January 2024 for large public-interest companies (with over 500 employees) already subject to the non-financial reporting directive, with reports due in 2025;
- From 1 January 2025 for large companies that are not presently subject to the non-financial reporting directive (with more than 250 employees and/or €40m in turnover and/or €20m in total assets), with reports due in 2026;
- From 1 January 2026 for listed SMEs and other undertakings, with reports due in 2027. SMEs can opt-out until 2028; and

Further resources

Read: Last minute Q&A responses from the ESAs on SFDR RTS interpretation: how do they impact your disclosures?

Watch: Asset Management Spotlight: EU SFDR: taking stock of recent EU developments and what you should know

Read: ESMA consults on developing Guidelines on funds' names with ESG or sustainability-related terms

Watch: our webinar on the EU proposal for a Corporate Sustainability Due Diligence Directive – a game changer? or read our alert on it here

Read: about human rights due diligence regimes in other countries Managing supply chain risks: reporting and diligence

- From 1 January 2028 for non-EU undertakings with reports due in 2029. The position for non-EU undertakings remains to be confirmed once the official final version of the CSRD is publicly available.

Greenwashing

Call for evidence: Managing greenwashing remains an EU priority focus, and following a request for input from the Commission in June 2022 in relation to greenwashing risks and the supervision of sustainable finance policies, the ESAs have published a Call for Evidence requesting:

- views from stakeholders on how to understand greenwashing and what the main drivers of greenwashing might be;
- examples of potential greenwashing practices; and
- any available data to help the ESAs gain a concrete sense of the scale of greenwashing and identify areas of high risks.

The deadline for submissions is 10 January 2023 and contributions will feed into the ESAs' finding for their progress reports due in May 2023 (final reports due in May 2024). The Commission will use the ESAs input to develop a definition for greenwashing and to assess and monitor greenwashing risks in the financial market, with a view to the further steps needed to ensure effective supervision and enforcement in this area.

ESG related terms in fund names: ESMA believes that to prevent misleading investors and prevent greenwashing, the use of ESG or sustainability-related terms in a fund name must be supported in a material way by evidence of sustainability characteristics or objectives that are reflected fairly and consistently in the fund's investment objectives and policy. Against this backdrop, ESMA has launched for consultation draft Guidelines on the use on funds' names with ESG or sustainability-related terms. The consultation closes on 20 February 2023 with ESMA expecting final Guidelines to be issued by Q2/Q3 2023.

ESG financial risk management

In October the EBA published its report on how to incorporate ESG risks into the supervision of investment firms. This report was generated by the EBA's mandate in the Investment Firms Directive to report on *"the criteria, parameters and metrics by means of which supervisors and investment firms can assess the impact of short-, medium- and long-term ESG risks for the purposes of the supervisory review and evaluation process"*.

The report is helpful in advocating a "proportionate" approach to supervision, by which it means "*taking into account investment firm's business model, size, internal organisation and the nature, scale, and complexity of its services and activities, as well as the materiality of its exposure to ESG risks.*"

It also recommends that the supervisory processes follow a gradual approach, prioritising the recognition of ESG risks in investment firms' strategies and governance arrangements, and later incorporating ESG risks in the assessments of risks to capital and liquidity.

Due Diligence

In February 2022, the Commission published its proposal for a Corporate Sustainability Due Diligence Directive (CSDDD). This sets out far-reaching due diligence requirements on a company's own operations, on its subsidiaries' operations and their value chains.

Although still unclear in many aspects, the proposal is broad and burdensome both in its geographic and its sectoral approach: it applies to both EU and non-EU companies over certain size thresholds; it also applies widely to the financial services sector.

This proposal has been subject to extensive lobbying to try to limit the scope on both these points. Sectorally, financial services trade associations have lobbied to have the financial services removed from scope altogether. Whilst this seems not to have been successful, there are early indications that asset management and funds may end up being excluded from scope or subject to lighter requirements. The banking sector, however, seems likely to remain in scope.

The Council has in recent days finalised its position on the Commission's draft. Parliament is also concluding work on its position. Once both institutions have adopted their positions, trilogues can commence; we expect this to happen early in Q2 2023.

The CSDDD is one of a suite of due diligence focused legislative proposals in the ESG space. The financial services are also keeping an eye on the EU proposal for a deforestation regulation, in which the Parliament has proposed including financial services in scope. It is hoped that this will be rejected as the compromise positions are worked out, and we expect to hear more on this and other issues around the proposed regulation before mid-December, when the nature-focused COP15 takes place in Montreal.

The UK government has announced that it will not replicate the CSDDD for the UK, on the basis that similar obligations already exist in other company legislation. It is also in the process of implementing regulations on illegal deforestation which will contain due diligence requirements.

Further resources

Watch: our video series to find out about human rights due diligence more broadly Business and Human Rights: Your questions answered

Read: the EU's Deforestation Regulation Proposal

Wholesale Markets Reform

The area of wholesale financial markets regulation has been the front-runner for EU and UK divergence.

Certain changes to the UK MiFID regime are already being implemented, with others subject to consultation and on track to be delivered in the near to medium term. 2023 will bring confirmation of the depth of divergence of the EU/UK MiFID regimes, as EU legislators decide to what extent they will follow some of the UK changes, as they finalise Level 1 changes to MiFID II and MiFIR and move on to the detailed requirements in technical standards.

ESG enhancements to EU MiFID suitability and governance requirements are of key relevance to asset managers, and these will bed down during 2023, with market practice likely to evolve in the medium term as demand for "green" products increases and related ESG data becomes more readily available.

There was good news in 2022 with the suspension of the EU CSDR mandatory buy-in regime. Although there is now uncertainty as to where the Commission will end up on this, there is support from the European institutions to remove this regime from CSDR altogether. This will be one to track in 2023.

Proposed amendments to EMIR (known as the Clearing Proposal) have just been published: these address clearing thresholds and distinguish between cleared and uncleared transactions – but are unlikely to be in force in 2023.

These topics and themes are explored in greater detail in the following pages.

MiFID II

ESG enhancements to EU MiFID

Since August 2022, EU investment managers and financial advisers have been required to obtain and incorporate their clients' "sustainability preferences" in the suitability assessment they undertake when making investment decisions / personal recommendations. ESMA only finalised its updated suitability guidelines, taking account of these ESG enhancements, in September 2022. Also since August, firms must account for sustainability risks in risk management and organisational rules, and any conflicts with client sustainability preferences must be identified and managed.

From 22 November, manufacturers and distributors subject to EU MiFID II must specify, as part of their target market assessments, any sustainability related objectives the relevant product is compatible with. ESMA has consulted on changes to its product governance guidelines to incorporate these ESG enhancements (alongside observations following a common supervisory action). The final guidelines are expected in Q1 2023, so (as with the ESG enhancements to the suitability assessments) firms are currently "in limbo" and have had to take a view on whether to implement in line with the draft guidelines.

Market practice will continue to evolve in 2023, and as more ESG data becomes available that may make the marketing of financial products as "green" easier for manufacturers and distributors, or as demand for "green" products increases.

There have been no ESG-related enhancements to the UK suitability or product governance rules yet. HM Treasury and the FCA have, rather, been monitoring the developments of global ESG standards (and perhaps the development of ESG data which could better support firms in their suitability and product governance related obligations) and plan to make ESG enhancements to the UK regime in due course. Timing for any UK enhancements is yet to be confirmed.

EU MiFID Review & UK Wholesale Markets Review

Although 2022 started with the EU MiFID Review "in the lead" (Commission legislative proposals having been published in November 2021), the UK quickly "overtook" the EU with changes to UK wholesale markets regulation. In turn, some of the immediate and upcoming UK changes have informed the EU MIFID Review, as EU policymakers consider whether some of the UK changes could have adverse competitive impacts for EU markets, unless they are replicated in the EU regime.

Overall, the themes of the reforms in the UK and EU are similar. Of most interest to asset managers will be changes that seek to address issues with overlapping UK/EU share and derivatives trading obligations (such as the deletion of the UK STO, changes to scope of the EU STO, and the introduction of DTO suspension mechanisms in both regimes); the quality of, and access to, market data (including through the creation of a consolidated tape provider per asset class); and changes to post-trade reporting waterfalls which are to be "decoupled" from whether or not counterparties have SI status (by introducing a new designated reporter status). Although many of the other changes to the UK and EU MiFID regimes are of more direct relevance to sellside firms, there may be knock on impacts for the buyside. For example, key changes are being made to the calibration of the equity and non-equity pre- and post-trade transparency regimes (ie waivers, thresholds, deferrals), and if these impact the risk profile of trades for sellside firms (eg if post-trade deferrals do not adequately protect liquidity providers from "undue risk") this may ultimately affect pricing or availability of liquidity.

Where are we in the UK, and what's to come in 2023?

In the UK, HM Treasury has been able to quickly take forward bolder regulatory changes (such as the removal of the UK share trading obligation and double volume cap), some of which were already included in the Financial Services and Markets Bill (and suspended until this legislation is finalised, with relevant transitional powers of the FCA extended until the end of 2023). The Bill also provides, amongst other things, for SIs to be allowed to execute client orders at mid-point within the best bid and offer for all trades. In addition, the Bill empowers the FCA to put in place a regime for consolidated tape providers, to describe post-trade risk reduction services which will be exempt from the UK derivatives trading obligation (DTO), and to suspend and modify the UK DTO. The Bill also envisages for the whole UK MiFID regime to be re-written (in the medium to longer term) into the FCA Handbook and put under FCA powers (as further described in our section on the Future Regulatory Framework below).

Further resources

- **Read:** Our blog post on ESMA's final updated suitability guidelines (September 2022)
- **Read:** Our note on ESMA's CP on the product governance guidelines (July 2022)
- **Read:** Our note on the Commission legislative proposals for the EU MiFID Review (November 2021)
- **Read:** Our note on HM Treasury consultation response to the UK Wholesale Markets Review (March 2022)
- **Read:** Our note on the Financial Services and Markets Bill (July 2022)

In H2 2022, the FCA started to consult on changes to equity transparency requirements and the creation of a new designated reporter regime for (equity and non-equity) post-trade reporting, and on the trading venue perimeter. We expect policy statements on these by the end of 2022 or in early 2023.

We also expect, around the end of 2022, an FCA report on the FCA's 2022 review of the cost, pricing and licensing terms for accessing wholesale market data.

In the first half of 2023, the FCA will publish a further consultation on transparency (or possibly two consultation papers covering equity and non-equity transparency separately). The FCA will also consult on what a consolidated tape might look like in the UK.

Where are we in the EU, and what's to come in 2023?

In the EU, both the Council of the EU and the European Parliament have been working on their respective amendments to the Commission proposals. It is clear that the EU institutions have been following UK wholesale markets reforms and the Commission has indicated that it considers that several changes to the UK regime could have adverse competitive impacts for EU markets, unless replicated.

We have seen several of the UK reforms picked up and replicated (even if not identically) in proposed changes to the EU Level 1 texts. For example, the European Parliament proposes a 5-year suspension of the EU double volume cap). The EU legislators have also proposed a regime similar to the new UK designated reporter regime for post-trade reporting (which decouples reporting obligations from SI status), and suggested exemptions for post-trade risk reduction services from several obligations.

At the time of writing, the Council and European Parliament appear to be resolving some key outstanding issues. On CTPs, both legislators appear to agree that a bonds CTP should be prioritised, followed by the CTP for shares/ETFs (but, whilst the Council is proposing to delay the derivatives CTP until issues around derivatives identifiers have been resolved, the Parliament suggests that a further cost/benefit analysis is needed before agreeing to a derivatives CTP at all).

One particular point of interest for asset managers is the proposal (endorsed by the Council) that the Commission should assess whether AIFMs and UCITS managers that conduct MiFID activities should be in scope of transaction reporting.

However, both legislators' positions are still subject to change. In terms of timing, at the time of writing:

> The Council is still working towards a compromise position by end of 2022 (although Q1 2023 is looking increasingly more likely, at the time of writing)

> The European Parliament hopes to publish its final report in January / February 2023

> Trilogues are expected to commence in Q2 2023 and to conclude in a final political agreement in Q3 2023

> Publication in the Official Journal and entry into force could then happen in Q3 / Q4 2023

> Amendments to MiFIR are proposed to apply 21 days after publication in the OJ

> Amendments to MiFID II will need to be implemented by Member States within 12 months

> The proposals envisage several delegated acts and changes to existing technical standards, as well as the creation of new RTS (eg to facilitate the creation of CTPs and related data standards). Consultations on these will follow once the legislative position on the Level 1 text is settled.

As part of the EU MiFID Review process, ESMA had published numerous review reports to the Commission with proposals to change Level 1 and Level 2 technical standards. In 2023 (and beyond), we can expect ESMA to consult on some of the RTS/ITS changes (eg on transaction reporting, algorithmic trading and equity / non-equity transparency), taking account of the final Level 1 text.

Further resources

Read: Our note on the latest European Parliament and Council positions on the EU MiFID Review (November 2022), although refinements to the positions summarised here are continuing to emerge as we approach further Council meetings during December 2022

Read: Our note on the FCA's CP on equity transparency requirements and designated reporter regime for post-trade reporting (July 2022)

CSDR

The CSDR's Settlement Discipline regime has continued to be beset with complications in 2022, although there is now hope that the industry's preferred outcome of no regulatory mandatory buy-in may be in sight.

After significant delay, the Regulatory Technical Standards on Settlement Discipline (Commission Delegated Regulation (EU) 2018/1229) finally entered into force on 1 February 2022. These RTS included the mandatory buy-in provisions and the cash-penalties framework.

Mandatory buy-ins

However, the European authorities had already agreed to amend CSDR to suspend the application of the mandatory buy-in rules (with the cash penalties provisions and settlement fails reporting provisions continuing to apply). This was based on lack of clarity on some critical open questions necessary for implementation of the buy-in requirements and uncertainty around the scope of the forthcoming CSDR Refit (in particular whether it would include amendments to the mandatory buy-in regime and the extent of any such amendments). Pending such amendment coming into force, ESMA issued a statement to NCAs proposing regulatory forbearance as regards compliance with the mandatory buy-in rules.

A Delegated Regulation suspending the application date of the mandatory buy-in regime until 2 November 2025 has now come into force.

We now await the outcome of the CSDR Refit to determine what form and scope, if any, a mandatory buy-in regime will take, although note that the ECB has advised that the entire application of the mandatory buy-in regime should be removed (see further below).

Cash penalties

The cash penalties regime has been in operation since 1 February 2022, despite the suspension of the rules on mandatory buy-in.

Since then, ESMA has consulted on changes to the cash penalties framework, specifically Article 19 of the Settlement Discipline RTS and in November, ESMA published its final report with proposed draft RTS. The current Article 19 provides for a specific collection and distribution process for cash penalties to be carried out by central counterparties (CCPs). The proposed amendment would remove the CCP-run separate process and would put the CSDs in charge of the entire process of collecting and distributing penalties according to Articles 16, 17 and 18 of the same regulation, establishing a single harmonised process for all transactions (both cleared and uncleared).

In its response to the consultation, the FIA commented that it: *"supports ESMA's proposals to remove the process of collection and distribution of penalties by central counterparties for cleared transactions. This will allow for the centralisation of the collection and distribution process of cash penalties for both cleared and uncleared transactions upon a single entity (central securities depository), allowing for a more straightforward and consistent approach, centred on the settlement step regardless of trading flow. Removing CCPs from the cash penalty process will reduce risk and improve the operating environment. FIA recommends that the amendment is introduced without additional delays, as the burden imposed by a bifurcated regime is ultimately detrimental to the smooth running of the CSDR cash penalty regime and the EEA's capital markets."*

ESMA's draft has now gone to the European Commission for adoption in the form of a Commission Delegated Regulation. Following adoption by the Commission, the Commission Delegated Regulation will be subject to the non-objection of the European Parliament and of the Council. It should come into force during 2023.

Further resources

Read: our client note on the Commission's CSDR Refit proposal

CSDR Review

Now that most of CSDR has been in force for some years, the Commission has carried out a review of how it is operating. In March, the Commission published a legislative proposal for a regulation amending the CSDR (known as the CSDR Refit proposal). The proposed amendments impact a range of areas covered by the legislation. In respect of the settlement discipline provisions, the proposal is to retain the mandatory buy-in regime so that it can be introduced if levels of settlement failures are not reduced by the other settlement discipline provisions but enable its application to be limited in various ways, for example as regarding types of transactions in-scope.

In August, the ECB issued an opinion (published in the Official Journal on 26 September 2022) welcoming the Commission proposal but making several suggestions. Among other things, the ECB advised that the entire application of the mandatory buy-in regime should be removed, stating that it would cause *'a significant interference in the execution of securities transactions and the functioning of securities markets'*. It also highlighted the *'non-availability of a buy-in agent'* in the market. In addition, if the Commission decides to retain mandatory buy-in, the ECB invites the Commission to consider excluding securities financing transactions entirely from its scope.

In October, the Parliament's Economic and Monetary Affairs Committee published a draft report on the Commission's CSDR Refit proposal in which it supported the ECB proposal. Its suggestion is to discard the regime completely and instead reintroduce into the Short Selling Regulation the central counterparty buy-in provisions against naked short-selling that already existed before the CSDR was implemented.

The Council is now working on its "General Approach". Word is that this is proceeding slowly on all points under discussion, with agreement slow to be reached with each Member State. We expect to see the General Approach by the end of 2022/early January 2023. Concurrently, Parliament is working on its compromise text. A report is expected in Q1 2023, after which trilogues (to negotiate the finalised regulation) can commence.

UK developments

The CSDR settlement discipline regime was not onshored as part of Brexit, and the UK is not proposing to introduce its own regulatory settlement discipline regime, although many UK asset managers are, nonetheless, indirectly impacted by the EU regime, as their EU brokers and custodians seek to pass on (contractually) many of their obligations, especially in relation to cash penalties.

The rest of CSDR (ie all other aspects than those relating to settlement discipline) was onshored. Part 1 of the Financial Service and Markets Bill contains a mechanism that allows for the revocation of the bulk of financial services retained EU law, which will include the UK CSDR, with such retained law being replaced by new UK legislation or regulatory rules. The government has not given a formal deadline for this, however, in the explanatory notes to the Bill, HM Treasury states that the process will take a number of years.

The Bill introduces a general rule-making power for the Bank of England over CSDs to enable it to undertake primary responsibility for setting regulatory requirements for these entities. The Bill also provides the Bank of England with a power to impose requirements on individual CSDs.

EMIR (EU developments)

Clearing

The Commission has conducted a targeted review of the central clearing framework in the EU, aimed at improving the competitiveness of EU CCPs, building clearing capacity in the EU and strengthening the EU's supervisory framework for CCPs. Following this review, the Commission's Proposal for a regulation amending EMIR ("Clearing Proposal") was published on 7 December 2022 and, as mentioned below, includes some significant changes, not limited to CCPs and EU clearing members. It remains to be seen how long it will take for the Clearing Proposal to be agreed with the Council and European Parliament and to come into force – this may well not be in the course of 2023. Furthermore, various provisions require technical standards to be made by ESMA and/or include a phase-in period.

The Clearing Proposal includes an amendment to the way in which the clearing thresholds are calculated under EMIR, to distinguish between cleared vs. non-cleared transactions rather than between exchange traded derivatives (ETDs) and OTC derivatives, which is helpful for EU entities that enter into derivatives transactions on UK venues, that are currently treated as OTC and therefore in-scope of the clearing threshold calculations.

EU entities that are subject to the clearing obligation under EMIR will be required to maintain an active account with an EU CCP for clearing of certain transactions (denominated in euro and other EU currencies) within the scope of the clearing obligation, EU clearing members and clients will also need to report annually to their competent authority as to the extent to which they clear through recognised third country CCPs.

The energy crisis has also driven developments relating to clearing, and amendments to increase the clearing threshold for commodity derivatives from €3bn to €4bn, and temporary expansion of the pool of collateral considered eligible for energy derivatives by CCPs, subject to certain strict conditions, came into force on 29 November 2022. The Clearing Proposal includes a permanent amendment to permit EU CCPs generally to treat bank guarantees and public guarantees as highly liquid collateral, though subject to conditions to be set by ESMA.

The exemption from clearing for EEA pension schemes is set to expire on 18 June 2023 and there is no scope under EMIR for further extension of this exemption. Both ESMA and the Commission have called for pension schemes subject to the clearing obligation to be prepared to clear in-scope transactions from 19 June 2023. On the other hand, the Clearing Proposal includes an amendment to EMIR to permit EU FCs and NFC+s to transact with third country pension scheme arrangements that are not subject to a clearing obligation under their national laws, without the EMIR clearing obligation applying.

Further changes to the scope of the clearing obligation in light of ongoing progress on interest rate reform are expected, and in particular extension of the clearing obligation to certain TONA products, and a wider range of SOFR products, reflecting increasing liquidity in such products.

ESMA has recently announced that it will withdraw recognition decisions for six CCPs established in India previously recognised under EMIR. The application of these decisions is deferred to 30 April 2023. Counterparties relying on ESMA recognition to clear through any of these CCPs will need to follow these developments closely and respond accordingly.

Intragroup exemptions from clearing and margining

The transitional exemptions from clearing and margining for intragroup transactions with counterparties in non-equivalent jurisdictions, are in the process of being extended to 30 June 2025. Regulatory forbearance is in place pending entry into force of these extensions. The Clearing Proposal sets out amendments to repeal the current "equivalence" provisions in Article 13 of EMIR, and to permit transactions with third country affiliates to be treated as intragroup transactions within the scope of the exemptions, unless the third country concerned is classified as high risk or non-cooperative with respect to money laundering, terrorist financing or tax evasion, or otherwise identified as a country that may not benefit from these exemptions by the Commission by way of delegated act.

Margin for uncleared derivatives

With initial margin now fully phased-in following completion of Phase 6 in September 2022, potential in-scope counterparties will need to conduct the annual AANA calculation process on an ongoing basis.

The EBA had consulted on RTS on initial margin model validation, and was expected to publish a final report and draft RTS in Q1 2023. However, amendments in the Clearing Proposal remove the mandate for these RTS suggesting that it is unlikely that these RTS will be made after all.

The temporary derogation from margin for single stock equity options and index options expires in early January 2024. Industry advocacy seeking continued exemption is underway. Counterparties relying on this exemption should monitor developments and make preparations for compliance with regulatory margining as necessary.

Further resources

Read: EMIR - new reporting requirements published in the Official Journal

Reporting

As mandated as part of EMIR REFIT, new technical standards on the reporting requirements and procedures for data quality under EMIR were published in the Official Journal in October 2022. Reports will need to be made in accordance with the new standards, following an 18-month implementation period, from 29 April 2024.

With the level of detail to be reported significantly extended, including 89 new reporting fields, and a total number of 203 reporting fields, the implementation period will provide valuable time for counterparties to make necessary changes to processes and documentation.

Another point to note on reporting under EMIR is that the Clearing Proposal includes amendments to remove the current exemption from reporting that can be applied for with respect to intra-group transactions involving an NFC.

Looking further ahead

The next EMIR Review was expected to be carried out over the next year or so, with the Commission due to assess the application of EMIR by 18 June 2024. However, some issues anticipated to be addressed in the EMIR Review have instead been covered in the Clearing Proposal, and the Clearing Proposal provides for the next EMIR Review to be deferred to five years from the Clearing Proposal amendments coming into force. This means a delay for changes that might usefully be made to EMIR but are not included in the Clearing Proposal, such as an exemption from the clearing obligation for post-trade risk reduction (PTRR) services.

UK developments

Clearing

Under UK EMIR, the exemption from clearing for UK and EEA pension schemes similarly expires on 18 June 2023, unless extended by the Treasury. Any pension scheme subject to the clearing obligation will need to ensure that it has arrangements in place to clear in-scope derivatives ahead of that date.

The Bank of England's policy on tiering and comparable compliance of third country CCPs was implemented on 1 December 2022. The Treasury has also announced that it intends to extend the Temporary Recognition Regime for third country CCPs by a further 12 months to 31 December 2024. Those relying on this temporary regime should, however, be mindful that a number of CCPs do not wish to seek recognition in the UK and have entered into the run-off period which will end on 1 July 2023. The derecognition decisions made by ESMA outlined above may also impact continued reliance on the regime post end-April 2023 in respect of affected Indian CCPs.

In the UK, interest rate products relating to SOFR and TONA are already in scope of the clearing obligation. The Bank of England has issued a Policy Statement indicating that contracts referencing USD LIBOR will be removed from the scope of the clearing obligation on 24 April 2023 (which is when CCPs will contractually convert outstanding USD LIBOR contracts).

There are no proposals in the UK to increase the clearing threshold for commodity derivatives as being introduced in the EU.

Intragroup exemptions from clearing and margining

The transitional exemptions from clearing and margining for intragroup transactions with counterparties in non-equivalent jurisdictions under UK EMIR will expire, unless extended by the Treasury, on 31 December 2023. Industry advocacy is expected on this point, particularly in light of the amendments to the EU intragroup regime set out in the Clearing Proposal.

Margin for uncleared derivatives

The PRA and FCA jointly consulted earlier this year on amendments to the UK EMIR margin rules, including amending the scope of eligible collateral to include any third-country funds, not just EEA UCITS, but subject to strict conditions and introducing a six-month implementation period for counterparties first coming in scope of margin requirements. It is hoped that these proposals will be implemented prior to the end of the year, when the temporary transitional provisions allowing EEA UCITS to be treated as eligible collateral for the purpose of the UK EMIR margin rules fall away.

As in the case of EMIR, following the completion of Phase 6, counterparties potentially in-scope for initial margin will need to conduct the annual AANA calculation process on an ongoing basis.

It is also the case that the temporary derogation for single stock equity options and index options under UK EMIR will expire from early January 2024, unless extended. As in the EU, affected counterparties should monitor developments and prepare for regulatory margin compliance for these products as necessary.

Reporting

The FCA and Bank of England have jointly consulted on changes to reporting requirements, procedures for data quality, and registration of trade repositories under UK EMIR. The great majority of these proposals were aligned with the EU EMIR reporting rules noted above. However, the UK proposals have not yet been finalised. As in the EU, it was proposed that there would be an 18-month implementation period before the new standards took effect. It therefore appears likely that the UK changes will take effect after the 29 April 2024 implementation date in the EU, though it remains to be seen whether the UK will align the timing with that in the EU.

Looking further ahead

Pursuant to the Financial Services and Markets Bill, UK EMIR, along with the bulk of retained EU law related to financial services, is set to be rewritten, primarily in regulators' rule books. Various provisions of UK EMIR are to be split between the existing regulatory perimeter under the regulated activities order (RAO) and the proposed designated activities regime (or DAR), a new regulatory framework for the regulation of certain activities relating to financial markets. There is no formal deadline for this process, which is expected to take a number of years to complete. In the case of EMIR, it seems likely that work will commence during 2023.

More substantive changes to UK EMIR are expected to result from the Wholesale Markets Review, including exempting PTRR services from the clearing obligation. These changes are expected to be included in primary legislation as Parliamentary time allows, so not expected to come into force in 2023.

IFR/IFPR

UK IFPR – where are we now, and what to expect in 2023?

As the first year under the new UK prudential regime for investment firms draws to a close, 2023 will see regulatory expectations move on from compliance on a "best efforts" basis to firmer expectations. Firms will also focus on their first public IFPR disclosures and continue work on refining their governance structures.

Supervisory expectations: ICARA & SREP (Pillar 2)

The FCA has been busy undertaking supervisory review and evaluation processes (SREPs) in H2 2022, starting with those larger IFPR firms that submitted their first internal capital and risk assessment (ICARA) forms (MIF007) early. We expect the FCA to publish their first observations from these early SREPs by the end of 2022 / in early 2023, and we understand that messages will likely include the following:

> **ICARA should be more holistic:** The ICARA process is made up of different parts, namely identifying potential material harms the business may pose to clients, markets and the firm itself; putting in place processes to mitigate these; undertaking stress testing (and possibly reverse stress testing); setting triggers and recovery actions to save the business; putting in place a wind-down plan; and identifying any additional capital or liquid assets which may be required to enable the firm to operate through the economic cycle and to wind-down in an orderly way, if needed. The FCA would like firms to pull these different strands together, through **senior manager / board involvement**, so that the business model and risk appetite of the firm are properly reflected in any stress testing and, in turn, in the firm's triggers / thresholds for recovery action and a potential wind-down.

> Given that wind-down planning is new for all IFPR firms, it is not surprising that this is a focus area of the FCA. There have been several FCA publications that are relevant to **wind-down planning and related liquidity needs**. Beyond the FCA's Wind-Down Planning Guide, FCA Finalised Guidance 20/1, and FCA Thematic Review 22/1, the FCA has also published findings from its review of liquidity and orderly wind-down in general insurance brokers, which includes commentary that will be of wider relevance to IFPR firms (eg on the need to consider group relationships, and senior manager involvement). IFPR firms should reflect these FCA expectations carefully in their ICARA processes, as we expect this to be a continued FCA focus for 2023 (particularly given current economic outlook).

> The FCA also expects IFPR firms to reflect **feedback from pervious (pre-IFPR) SREPs** or to discuss relevant changes in circumstances with the FCA.

> As the FCA is becoming more data led, and because data from the various MIF reports is used to identify prudential risks that may impact UK markets, the regulator expects firms to focus on **data accuracy**. In 2022, the FCA clarified some of the MIF forms and guidance to improve data quality, and we can expect sharper FCA focus on firms that get it wrong during 2023.

All IFPR firms should be completing a first review of their ICARA processes by the end of 2022 (since the review is required annually). Any IFPR firms that have not yet submitted their first ICARA report (MIF007) to the FCA will need to do so in early(ish) 2023. We expect the FCA to continue their SREPs throughout 2023 – and this will likely involve **the first "sectoral" SREPs** where FCA feedback may be directed at whole sectors rather than individual firms.

IFPR disclosures (including remuneration and ESG disclosures) (Pillar 3)

In 2023, the first public disclosures under IFPR will be due. The **types of IFPR disclosures** required depend on the classification of the relevant firm, with:

> non-SNI firms required to make disclosures on risk management, own funds, own funds requirements, governance arrangements, remuneration and (if the non-SNI firm is above the committee threshold) its investment policy and more detailed information on remuneration structure and material risk takers (MRTs);

> SNI firms with AT1 capital required to make disclosures on risk management, own funds and own funds requirements; and

> All SNI firms required to make a minimum level of remuneration disclosure about the key characteristics of the remuneration policy.

Further resources

Explore: Our IFR webpage

Read: Our briefing summarising IFPR remuneration disclosures for all investment firms

Public IFPR disclosures are due **annually**, and **first disclosures** will be due as follows:

> Public IFPR disclosures will be due on the date on which the relevant investment firm publishes its financial statements (or, if it does not publish financial statements, the date on which it is required to submit its solvency statement to the FCA).

> For firms whose **financial year ends on or before 30 December 2022**, the first IFPR disclosures on own funds, own funds requirements and governance will be made from their 2022 year end date (ie for the first time on the date the firm's 2022 financial statements are published). Risk management and investment policy disclosures (to the extent applicable to the firm) only start from their 2023 year end date (ie are first due on the date the firm's 2023 financial statements are published).

> For firms whose **financial year ends on 31 December 2022**, the first IFPR disclosures on own funds, own funds requirements and governance, as well as risk management and investment policy disclosures (to the extent applicable to the firm) will be due on the date the firm's 2022 financial statements are published.

> The **timing of the first IFPR remuneration disclosures** does not depend on a firm's year end date. IFPR remuneration disclosures are first due after the **end of the first performance period commencing on or after 1 January 2022**. Like the other IFPR disclosures, remuneration disclosures will be due on the date on which the firm publishes its first annual financial statements following the end of that first performance period.

IFPR firms will be busy pulling together relevant data, and decisions about proportionality in the context of qualitative disclosures will be key.

As regards **ESG disclosures**, the FCA had delayed this aspect of the IFPR regime while ESG standards were still evolving globally. But we expect an FCA consultation on IFPR ESG disclosures before the end of 2022, and firms will be busy engaging with this (including, where groups operate across the UK and EU, assessing whether and how relevant ESG disclosures can align across the regions).

Governance

We expect firms to continue their focus on establishing governance structures in line with the IFPR requirements in 2023, noting that some groups with non-SNI firms that are above the committee thresholds continue the recruitment process for the required NEDs and their work on entity and group committee structures (or may be applying for waivers from the FCA to be permitted to hold certain committees at group level).

Given the FCA's comments on the ICARA process (see above), firms should also assess the governance of their ICARA processes, and in particular the level of senior manager and board level input to ensure that ICARA is run holistically and reflects the firm's risk appetite and specific material harm profile throughout, including when setting recovery and wind-down triggers.

2022 saw much discussion of the change of the definition of "significant IFPRU firm" to "significant SYSC firm", which (due to the low commission threshold) would have meant that many portfolio managers and investment advisers would be caught and subject to enhanced SMCR requirements. An FCA consultation proposed to limit the changes to firms that would have been IFPRU firms prior to commencement of the IFPR regime, but to do so for SMCR purposes only. This means that relevant firms could still be subject to other provisions which apply to "significant SYSC firms", most notably the limits to directorships. We expect the FCA's final position on "significant SYSC firms" by the end of 2022 or in early 2023.

Remuneration

IFPR introduced a new remuneration regime for performance periods starting on or after 1 January 2022 for all UK investment firms, the "MIFIDPRU remuneration code" (SYSC 19G in the FCA Handbook). Firms have been navigating new complex rules and some challenging issues, including the following:

> **Scope:** Identifying MRTs on the basis of qualitative criteria only, particularly those based outside the UK, and the impact on their pay, and treatment of UK branches of third country firms;

> What does "risk adjustment" mean in relation to bonus pools, the process involved, and what will be the FCA's approach to assessing remuneration practices; and

> **Pay-out structure:** Appropriate deferral periods, regulatory and HR impacts of setting a high fixed-variable pay ratio, using parent company shares for the non-cash instruments requirement, and alignment and treatment of severance pay.

These will continue to be addressed during 2023 as the rules bed down. Experience of similar issues which banking groups have had to deal with in the context of the CRD regime may be of some assistance.

EU IFR/IFD – where are we now, and what to expect in 2023?

In the EU, although the new prudential regime for EU investment firms has been in place slightly longer, several Member States implemented the requirements late. For 2023, we expect the areas of focus of NCAs and EU investment firms to be broadly similar to those outlined for the UK IFPR above, with regulatory expectations growing beyond "best efforts" compliance.

As different NCAs complete SREPs for larger firms in their relevant market, in 2023, we will start to see observations about implementation and required improvements, most likely (as in the UK) on data accuracy and the new ICARA processes, particularly on the new wind-down planning requirements and related liquidity. The challenge for some firms that are part of investment firm groups will be to navigate and reflect the nuances of commentary from different NCAs.

IFR public disclosures (Pillar 3) and ESG

Unlike UK IFPR firms, EU Class 2 investment firms, and Class 3 investment firms with AT1 capital, have already had to complete their first annual (Pillar 3) disclosures (which cover the same ground as those outlined in the UK IFPR section above). These disclosures were due when relevant firms published their first annual financial statements after 21 June 2021 (when IFR started to apply).

But (unlike the UK IFPR), from 26 December 2022, the EU regime (Art 53 IFR) requires Class 2 EU investment firms to disclose information on ESG risks, including physical risks and transition risks (which are defined in the 2021 EBA report on the management and supervision of ESG risks for credit institutions and investment firms, and as complemented by the EBA's October 2022 report on incorporating ESG risks in the supervision of investment firms). These ESG disclosures will need to be made once in the first year (ie when a Class 2 firm next publishes its annual financial statements after 26 December 2022), and biannually thereafter.

On the treatment of ESG risks, the EBA is also mandated to publish its report under Article 34 IFR on the prudential treatment of assets exposed to activities associated with environmental or social objectives (which was originally due in December 2021). The EBA's May 2022 discussion paper on the role of environmental risks in the prudential framework explores the interaction of environmental risks with the CRR and IFR/IFD prudential frameworks, and considers whether certain aspects of the IFR/IFD regime (including K-Factor calculations) could be amended to specifically incorporate environmental risks and/or to what extent changes to the IFR/IFD regime could reflect similar changes to the CRR prudential regime applicable to credit institutions, subject to the principle of proportionality. The outcomes from this discussion paper should feed into the EBA report under Art 34 IFR, which we expect during 2023 (possibly as soon as Q2 2023).

IFR/IFD "Class 1" group test

At the moment, the test that determines whether an EU investment firm is a "Class 1" firm and therefore subject to the CRR prudential regime, instead of IFR/IFD, includes a group test. As discussed in this earlier client note, the global reach of this group test can lead to Class 1 classification where own account dealing, underwriting / placing activities of a global groups exceed relevant thresholds, even where only a minimal level of these activities is carried on by an EU group entity. We are aware that the Czech Council Presidency recently proposed to amend the group element of the "Class 1" test so that it only takes account of EU firms within the group which conduct the relevant activities / relevant EU assets (ie changing this from a global to an EU group test). This would be a welcome change for some global groups. It appears that this potential change may be included in the Council compromise amendments to MiFIR (as part of the EU MiFID Review). Please refer to our section on MiFID II for more detail on the expected timings of the EU MiFID Review. But if this proposal is accepted during trilogues, this change could become effective towards the end of 2023 or in early 2024.

Future UK Regulatory Framework

A broad programme of work is underway to shape the future of financial services regulation in the UK. The changes will impact all financial entities that operate in the UK's financial system.

Future regulatory framework

The **Financial Services and Markets Bill** delivers the outcomes of the government's future regulatory framework review. This review proposed a return to a model where regulators, rather than legislators, take on primary responsibility for setting the regulatory obligations which apply to firms. The Bill is therefore relevant to all firms operating in the UK. Although the Bill is expected to be enacted in spring 2023, it does not take effect in full straight away. The Treasury must pass commencement regulations for most provisions of the Bill before they start to take effect.

Since the end of the Brexit transition period, the UK government has described the process for retaining EU law on the statute books as a "short-term bridging measure". For retained EU law relating to financial services, the Bill sets up the process for a **"lift and shift"** of regulations off statute books and into regulators' rulebooks. This represents a significant challenge for firms to track where the rules that apply to them end up. The Treasury plans to take a phased approach, prioritising policy areas which can advance the government's objective for a more competitive, open, technologically-advanced and green financial services sector.

There are some areas of retained EU law which apply to unregulated as well as regulated entities, for example the UK Short Selling Regulation. To avoid bringing these into the scope of the regulated activities regime, the Bill empowers the Treasury to set up a new **designated activities regime**, or DAR. The Treasury would make regulations specifying the designated activities, for example activities related to entering into derivative contracts or offering securities to the public. The regulations will stipulate whether that activity is prohibited or permitted subject to compliance with certain rules. The Treasury and the FCA can both make rules which apply to the activity. Rules made under the DAR are limited to the designated activity and do not apply to other activities of the firm.

The Bill's repeal and replacement of retained EU law will take place in the context of wider reforms. A **Brexit Freedoms Bill** proposes repealing all retained EU laws unless ministers restate or replace it before the end of 2023. Retained EU law relating to financial services are carved out of this deadline because these will be reformed under the Financial Services and Markets Bill. Even so, other aspects of the Brexit Freedoms Bill will apply to financial services regulation, such as the removal of the special status of retained EU law. The end-2023 deadline will also put political pressure on the Treasury and regulators to accelerate the transfer of financial services regulations.

The Financial Services and Markets Bill makes other structural changes to the regulatory framework. For example, the Bill changes the regulators' objectives. A new secondary objective for the FCA and PRA requires them to take into account the **international competitiveness** of the UK financial sector when carrying out their functions, including rule-making. The government had mooted including a "call-in" power for the Treasury to direct regulators to change their rules in some circumstances but has now shelved this idea after the regulators suggested it could undermine their independence.

Further resources

- **Explore:** Future regulatory framework webpage
- **Read:** Financial Services and Markets Bill sets future for UK regulation
- **Read:** Retained EU law to expire, unless Ministers restate or replace it
- **Read:** Treasury asks whether the OPE and other aspects of the UK's overseas regime are working effectively
- **Read:** A timeline of UK cryptoasset regulation

Review of the overseas framework

The government is expected to consult on changes to the UK's overseas framework. This follows a 2020 Treasury paper which called for feedback on how different overseas regimes are used. These regimes include the **overseas persons exclusion**, equivalence under UK MiFIR, the recognition of overseas investment exchanges and exemptions to the financial promotions regime. The government may look to remove overlap between these regimes. For example, as it stands, if the UK makes a positive equivalence determination under MiFIR, the OPE would not be available for firms based in the relevant jurisdiction after three years.

Financial promotions

The Financial Services and Markets Bill will amend the **financial promotions** restriction. The effect of this change is that an authorised person may only approve the content of a communication by an unauthorised person if it has permission from the FCA to approve such promotions. This is part of the new gateway for authorised firms to pass through before they can approve the financial promotions of unregulated firms. Firms are also having to implement recently-imposed stricter rules which apply when they market high-risk investments, such as unlisted shares (see Putting Consumers First).

Temporary permissions

The UK's temporary permissions regime is due to close at the end of 2023. Firms with temporary permission which do not receive a UK licence and cannot rely on exemptions will need to wind down their UK operations. The financial services contracts regime has been set up to help firms in this position. It allows firms five years to run off existing contracts. Firms in the FSCR may not write new UK business and are limited to providing services which are necessary for the performance of pre-existing contracts.

The FCA's temporary marketing permissions regime (TMPR) allows EEA funds that were passporting into the UK at the end of the Brexit transition period to continue to be promoted in the UK. The TMPR is due to close for most funds at the end of 2023, although EEA UCITS may continue to be marketed in the UK until 31 December 2025. The aim is that these funds should be able to move from the TMPR into the UK's new Overseas Funds Regime.

PRIIPs

The legislation surrounding PRIIPs has proven to be one of the more contentious pieces of financial regulation in recent times. Notwithstanding the core objective of the regime being to facilitate consumers in making informed decisions through the increased transparency and comparability of different packaged retail investments and insurance products, the KID has proven to be problematic.

Changes to both the UK and EU PRIIPs regimes have been made to address these concerns, but more changes are expected, and a key focus in the coming months will be on how the UK and EU will develop and diverge the rules in this area, both in the short and long term.

EU – imminent changes

Changes to the PRIIPs Delegated Regulation including:

- changes to performance scenarios;
- changes to costs calculation and presentation; and
- PRIIPs manufacturers ability to increase SRI to be conservative where risks not accurately reflected; and
- changes to prescribed text, take effect on 1 January 2023.

This also aligns with the ending, on 31 December 2022, of the transitional provision allowing provision of a UCITs KIID (meaning that PRIIPs KID apply to UCITs from 1 January 2023).

EU – longer term plans

Following a request from the Commission in July 2021 for advice from the ESAs (on specific aspects of the PRIIPs regulation, including its scope, practical application and use of the KID), and following their own public call for evidence in 2021, in May 2022, the ESAs suggested changes to the EU PRIIPs rules via advice to the European Commission. In their advice the ESAs have gone beyond the specifics of the Commissions mandate and present recommendations on a range of issues relating to the PRIIPs regime.

Key proposals include:

- Changing the KID eg to include a very short-form summary or “dashboard” at the top of the KID;
- Adding a new section to show where a PRIIP has sustainable investment as its objective or it promotes environmental or social characteristics, aligned with the SFDR;
- Replacing “appropriate performance scenarios” with “appropriate information on performance” (something the FCA has already changed in the UK version of PRIIPs);
- Requiring KIDs to be machine-readable and formatted for use on phones.

The ESAs note that they have not been able to conduct consumer testing but think that it would be important to do so before amending the PRIIPs Regulation.

Next steps

The ESA’s advice will feed into the Commission’s strategy for retail investments in Europe, which it currently plans to release in Q1 2023.

UK – new rules in force

The FCA’s new rules and guidance on the UK PRIIPs regime took effect on 25 March 2022. A transition period means that firms have until 31 December 2022 to implement changes – this applies to both the new DISC rules and guidance in the FCA’s Handbook and the changes to the PRIIPs RTS.

UK – future changes

Further resources

Read: our note on the FCA changes to the UK PRIIPs regime

Read: our note on the EU proposals

These changes that are now in force represent a "first step" for improving the PRIIPs rules in the UK, and the FCA is expected to undertake further work in this area with HM Treasury. Topics for discussion are expected to include how the PRIIPs KID could be improved to work for digital investments, the inclusion of past performance in the KID and the slippage methodology for calculating transaction costs.

At the second reading of the Financial Services and Markets Bill 2022-2023 in the House of Commons on 7 September 2022, then former Chancellor Rishi Sunak urged the government to go further by "repealing PRIIPs and replacing it with a tailor-made regime specifically for UK markets". Whether more will now be made of this suggestion remains to be seen.

Timing

It is not yet clear when this wider review of the UK PRIIPs regime will begin.

UCITS

On 14 July 2022, the FCA updated its webpage that summarises the rules that apply to firms in the temporary permissions regime (TPR) and fund operators in the temporary marketing permissions regime (TMPR).

The FCA has added a new section on disclosure requirements for EEA UCITS in which it advises that, in the UK, the exemption from the requirement for EEA UCITS to produce a PRIIPs KID lasts until 31 December 2026. The FCA can confirm that this exemption applies to both EEA UCITS recognised under s272 of FSMA and those recognised under the TMPR. This means that, when being marketed to retail investors in the UK, EEA UCITS that are recognised under either s272 of FSMA or the TMPR must produce a UCITS KIID.

The FCA also notes that the TMPR is due to end on 31 December 2025. The FCA is engaging with the Treasury on the disclosure requirements that would apply in the event of an equivalence decision under the Overseas Funds Regime.

AIFMD and UCITS Directive Review

AIFMD has fundamentally changed the way alternative fund managers operate, and has largely been viewed as a success story. However, since its inception the plan has always been to review the framework to ensure that it is fit for purpose. This review process saw the publication in November 2021 of EU Commission proposals to amend AIFMD. As certain issues from the review were relevant to UCITS, amendments have also been proposed to the UCITS Directive.

We expect to see negotiations over the text of the proposals between the European Parliament, Commission and the Council over the coming months.

The proposals and direction of travel

Since the publication of the Commission proposals, the Council of Europe has published its position paper. The Parliament has not yet agreed its position, although a rapporteur's draft report was published on 16 May 2022. Discussions between the political groups continue, and progress is being made, however, due to ongoing disagreement on the final compromise amendments a final vote in the ECON Committee has been postponed to January 2023.

Key changes include:

> Harmonisation and tightening of the requirements around minimum substance of AIFMs and UCITS ManCos, and additional requirements at the authorisation stage (albeit no fundamental changes to the ability of AIFMs and UCITS ManCos to delegate their functions);

> New rules and requirements for loan origination;

> New requirements around liquidity management for both UCITS and open-ended AIFs (in particular NCAs are now empowered to require that an AIFM/UCITS Manco activates or deactivates a liquidity management tool);

> Targeted amendments to rationalise the requirements around depositaries; and

> New and detailed eligibility, conduct and reporting requirements for AIFs that undertake lending.

It appears that the long promised AIFMD passport for non-EU AIFMs is still a long way off.

Non-EU AIFMs operating under Article 42 AIFMD should note that some of the new requirements will also apply to them.

Next steps

Once the EU Parliament has agreed its position, trilogue discussions between the three legislators to agree the final text can then commence. These trilogues are still currently expected to take place in Q1 2023.

ELTIF 2.0

The European Parliament and the Council of the EU have reached a provisional agreement on the review of the European Long-term Investment Funds ("ELTIF") Regulation. The updated regulation is anticipated to make these investment funds more attractive to asset managers and investors and increase the number of these investment funds in Europe.

Provisional agreement to amend ELTIF Regulation

The Commission notes that the advantages of ELTIFs have been diminished by restrictive fund rules and barriers to entry for retail investors, and, in short, that the ELTIF Regulation has to date not been extensively used. The Commission's proposals adopted in November 2021 aimed to make ELTIFs the "go-to" fund structure for long-term investments.

Following negotiation between the Council and European Parliament this year, on 19 October 2022, the Council announced that a provisional agreement has been reached on the proposed Regulation with key priorities reflected in the text, including:

> a redesign of the ELTIF framework to allow the EU to channel more financing to SMEs and long-term projects to help achieve the digital transition;

> clarification of the scope of eligible assets and investments, the portfolio composition and diversification requirements, the conditions for borrowing and lending of cash and other fund rules, including sustainability aspects; and

> the introduction of rules to make it easier for retail investors to invest in ELTIFs while ensuring strong investor protection.

"Green" ELTIF

The Parliament own set of proposals on the ELTIF Regulation (published in June 2022) included a proposal for the creation of an optional subcategory of ELTIFS "marketed as environmentally sustainable". It remains to be seen in the final text whether this proposal has been retained.

Next steps

The European Parliament is scheduled to consider the proposed Regulation during its plenary session to be held from 1 to 2 February 2023. Following technical and legal revisions, the final text will be submitted for adoption by the Council and the European Parliament, and the new rules should apply nine months after their publication in the EU Official journal.

Further resources

Read: Visit our ELTIF webpage for more information.

Watch: Our webinar on the original ELTIF proposals

Read: Our blog post

Future UK Funds Regime: Long Term Asset Fund

The FCA has published a consultation paper with proposals to broaden distribution of the long-term asset fund (the "LTAF") to retail investors in the UK subject to certain restrictions, as well as increasing the amount of exposure that some other authorised retail funds can have to the LTAF.

The draft rules also propose modifications to broaden pension scheme coverage.

Final rules are expected in early 2023.

Broadening retail investment coverage

When creating the LTAF regime (which came into force on 15 November 2021), the FCA indicated that its intention was to do so in two stages – focusing initially on the framework for distribution to professional, high net worth and sophisticated investors (mostly targeted at DC pension scheme default arrangements), and then consulting on broadening access to retail at a future date (the intention being to ensure that investment in long-term illiquid assets is a viable option for investors with long-term investment horizons who understand the risks).

The latest consultation takes on this second stage, with proposed amendments to the rules in a number of areas:

> Classification of LTAFs as a "restricted mass market investment" (RMMI) in line with its new financial promotion rules (see Putting Consumers First below)

> Extension of certain mainstream retail fund rules (ie those which apply to UK UCITS and UK NURS) to afford additional protections for retail customers. Firms that manufacture, manage or distribute an LTAF to retail investors are also required to comply with the Consumer Duty;

> Application of the FCA's Direct offer financial promotion (DOFP) rules to LTAF; and

> Amendments to the rules applicable to NURS Funds of Investment Funds to better enable them to invest (subject to maximum investment limit) into LTAFs.

Broadening pension scheme coverage

The FCA is proposing to amend the rules for unit-linked products (the "permitted links" rules) to extend the distribution of LTAFs and other illiquid assets to members of DC pensions schemes and more widely by:

> permitting the broadening of the distribution of LTAFs via self-select options in qualifying schemes (subject to guidance stating the insurer must satisfy itself that protections are in place to prevent investors over-exposing themselves to the LTAF-linked fund);

> extending the distribution of LTAFs where investors in a long-term unit-linked product have appropriate professional support on fund selection; and

> giving equivalent status to that currently afforded to LTAFs via the permitted links rules to other illiquid assets where the unit-linked product is part of the default arrangements of a qualifying scheme (where conditions for securing an appropriate degree of consumer protection can be met).

The FCA suggests that, given its (at least) 90-day notice period for redemption, the LTAF would be considered a non-standard asset for self-invested personal pensions (SIPPs).

Next steps

The consultation closed on 10 October 2022. The FCA expects to publish its final rules in early 2023.

Further resources

Read: Read our note on the FCA consultation

Read: Read our note on the LTAF here

Future UK Funds Regime: Overseas Funds regime

The UK Government enacted a new Overseas Funds Regime ("OFR") in the Financial Services Act 2021, providing a fast track framework for non-UK funds to be recognised and registered for marketing to retail investors in the UK after Brexit.

During its consultation, HM Treasury stated that the regime has the potential to "promote the interconnectedness of financial markets and consumer choice, advance trading opportunities around the world, and support bilateral agreements with other countries."

We expect more work by the FCA in the coming months to operationalise the OFR.

Background

Prior to Brexit there were in excess of 8,000 EEA UCITS marketed in the UK under the passporting regime.

Whilst many EEA funds still access the UK via the TMPR (the TMPR period for UCITS running to the end of 2025), the main access route for those who cannot benefit from a passport to market to retail investors in the UK outside the TMPR is via an application for individual recognition under s272 FSMA. This requires an in-depth assessment of the fund, the operator and the depositary to ensure that a fund affords adequate protection to investors and meets several other tests.

Given the significant number of funds which will need to be assessed for suitability to market in the UK after the TMPR, there has long been recognition that a more streamlined process is needed to achieve this is in a timely manner. The OFR gives HM Treasury powers to determine whether an overseas jurisdiction and type of fund is "equivalent" to a UK authorised fund. If so, that type of fund can benefit from a fast track process to be recognised and registered for marketing to retail investors in the UK.

The s.272 FSMA route to marketing recognition will remain available for funds which are not eligible to be recognised through the OFR.

Next steps

Although the OFR has now been enacted, HM Treasury must still undertake the relevant equivalence analyses before any overseas fund can benefit from the fast-track regime. It remains unclear at this stage when the first decisions will be made regarding jurisdictions which may be deemed equivalent under the regime.

FCA work to operationalise the OFR is also still underway. The FCA's regulatory initiatives grid still notes that the FCA intends to consult on various aspects of the handbook rules to ensure OFR funds are appropriately captured. These had been expected in Q3/Q4 2022, but now look to be pushed to 2023. Given the current 31 December 2025 deadline, and the indicative two year time frame the FCA expects that it will need to process the volume of fund assessments before that date, we expect these consultations to commence in the coming months.

Further resources

Read: Our note on the UK Overseas Funds Regime

Operational resilience

How would you show you are ready to withstand a cyber-attack, failed IT upgrade or an outage at a service provider? New and incoming rules on operational resilience expect UK and EU firms to follow a more prescriptive approach when preparing for disruption. Financial services authorities are also taking on more responsibility for overseeing unregulated tech providers to monitor and mitigate concentration risk in the sector.

UK operational resilience regimes

The UK's operational resilience regimes are now in force. UK asset managers in the scope of the enhanced SMCR regime must comply with the FCA's operational resilience rules. PRA-supervised firms, such as banks and the largest investment firms, must also comply with the PRA's regime.

Firms in the scope of these rules should already have set impact tolerances for all their important business services and mapped the resources they rely on to deliver these services. They will also have drawn up "self-assessment" documents evidencing how they comply with the new rules. These records must include justifications and explanations for key decisions made during implementation. The challenge for firms is to maintain these documents so that they are up to date when the regulators request them.

Firms are now focusing on building out the sophistication of their mapping exercises and scenario testing. This is so that vulnerabilities can be addressed no later than the 31 March 2025 deadline. After this date, firms must remain within impact tolerance levels in the event of severe but plausible disruption. Firms will want to use feedback from testing to calibrate their impact tolerances over the next couple of years before this rule starts to apply.

Senior management will be held to account for delivering operational resilience. The board must approve and regularly review the (potentially voluminous) documentation which records compliance with the regime. The FCA has made clear that responsibility for signing off operational resilience documents should not be delegated to someone that is not on the board.

To meet the rising regulatory expectations, senior management will need to receive more status updates on their institution's resilience. This management information, including incident reports, should be timely and offering appropriate detail. Training and advice should be made available to ensure that they can engage with this information and oversee the real resilience of the business effectively.

New rules are also in the pipeline. For example, the regulators are due to consult on new operational incident reporting requirements. This underlines what many in the industry have already recognised which is that operational resilience is not a regulatory change project with an end-date but rather an ongoing exercise.

UK critical third party regime

Encouraging individual firms to build their resilience to operational disruption is only one piece of the puzzle. Another relates to the systemic risks that can emerge where several regulated entities rely on a common service provider. To better monitor and mitigate this concentration risk, the UK regulators will be empowered to oversee some unregulated tech firms providing critical services to the regulated sector.

The Financial Services and Markets Bill sets the oversight regime for critical third parties. Once the Bill is enacted and the relevant provisions brought into force, the government may designate a person who provides services to financial services firms or financial market infrastructure as a "critical third party". This designation would be on the basis that the failure of, or disruption to, those services could threaten the stability of or confidence in the UK financial system.

Further resources

- **Explore:** Our resources on operational resilience
- **Watch:** DORA Explored: How the EU's rules for digital operational resilience affect you
- **Read:** Cyber Security Handbook – The Essential Handbook for In-house Counsel
- **Read:** A guide to the EU's new digital package

When making a designation, the Treasury must take into account two factors. The first is the materiality of the services to the delivery of activities that are essential to the UK economy or to the stability, or confidence in, the UK financial system. The second is the number and type of recipients to which the third party provides services. Notice must be given to the potential critical third party and a reasonable period allowed for written representations.

The FCA, PRA and Bank of England will make rules in connection with the provision of critical services. They are expected to use these powers to introduce minimum resilience standards for critical third parties and to require them to take part in a range of resilience tests and sector-wide exercises. The detailed rules will be the subject of a consultation paper in 2023. The Bill also gives the regulators additional investigatory and enforcement powers to supervise and enforce the regime once it starts to apply.

EU DORA

Over 20,000 firms in the EU will need to get themselves ready to implement the digital operational resilience act, or DORA. The regulation aims to harmonise higher resilience standards across the EU and across different sectors of the financial services industry. Virtually all EU regulated financial entities will be in scope, including AIFMs, UCITS ManCos and MiFID investment firms.

DORA obliges firms to take a more robust approach to ICT risk management. Like the UK regime, DORA expects sources of ICT risk to be identified, interdependencies mapped and risk tolerance levels set. Resilience documentation must be consolidated and made available to regulators.

DORA includes rules on testing, responding to lessons learned and setting a communications strategy. Unlike the UK regime, DORA explicitly requires firms to use up-to-date, reliable and resilient ICT. It also specifies that the management body is ultimately responsible for managing ICT risks.

A significant headache for many firms is the challenge of implementing a global resilience strategy in a way which is compliant with local regimes. Although the outcomes of the UK and EU regimes are largely aligned, the detailed requirements differ. For example, DORA's concept of a risk tolerance limit is not the same as the UK definition for impact tolerance. Other jurisdictions are also developing rules aimed at building the operational resilience of their financial sectors.

DORA includes an equivalent to the UK's critical third party regime. It allows the European Supervisory Authorities to designate and directly oversee what DORA calls "critical ICT third party service providers". The definition of "ICT services" is widely drafted and will include not only cloud provision but a range of other digital and data services as well.

The assessment for whether a provider is designated as "critical" takes into account the systemic impact that disruption at the third party could have on the stability, continuity or quality of financial services. This includes considering the degree of substitutability of the services and the number and importance of the financial entities receiving the services. One of the ESAs will be appointed as Lead Overseer for each critical ICT third party service provider.

There are exceptions to the designation process. For example, it does not apply in relation to:

> financial entities providing ICT services to other financial entities;

> ICT third party service providers that are subject to other EU oversight frameworks; and

> intra-group service providers.

These exemptions are important because of the requirements on critical ICT third party service providers. For example, one of the requirements in DORA is that EU financial entities cannot use a critical ICT third party service provider based outside the EU unless that third party sets up a subsidiary in the EU within 12 months of designation. This will be particularly impactful for overseas tech firms currently providing services into the EU.

Although designation falls short of authorisation as a financial entity, DORA gives the ESAs wide powers over critical ICT third party service providers. The Lead Overseer is responsible for assessing whether the provider has comprehensive, sound and effective rules, procedures, mechanisms and arrangements to manage the ICT risks they pose to financial entities. It will have the right to request or require access to information, including relevant business and operational documents, contracts, policies, security audit reports and incident reports. The Lead Overseer will also have broad powers to conduct investigations and on-site inspections of any premises of critical ICT third party service providers, including overseas premises.

DORA takes effect after a two-year transition period. This means its requirements are expected to start applying from 1 January 2025. As well as setting up the various processes relating to the oversight regime for critical ICT third party service providers, the European Supervisory Authorities must develop over twelve sets of technical standards. Most are due by the end of 2023. These include more detailed requirements about financial entities' ICT response and recovery plans, ICT business continuity processes, and contractual arrangements for critical and important functions. ESMA also plans to finalise its opinion on market outages in early 2023.

This wave of technical standards presents a resourcing challenge for the ESAs. It also has the potential to complicate matters for firms around halfway through their DORA implementation projects.

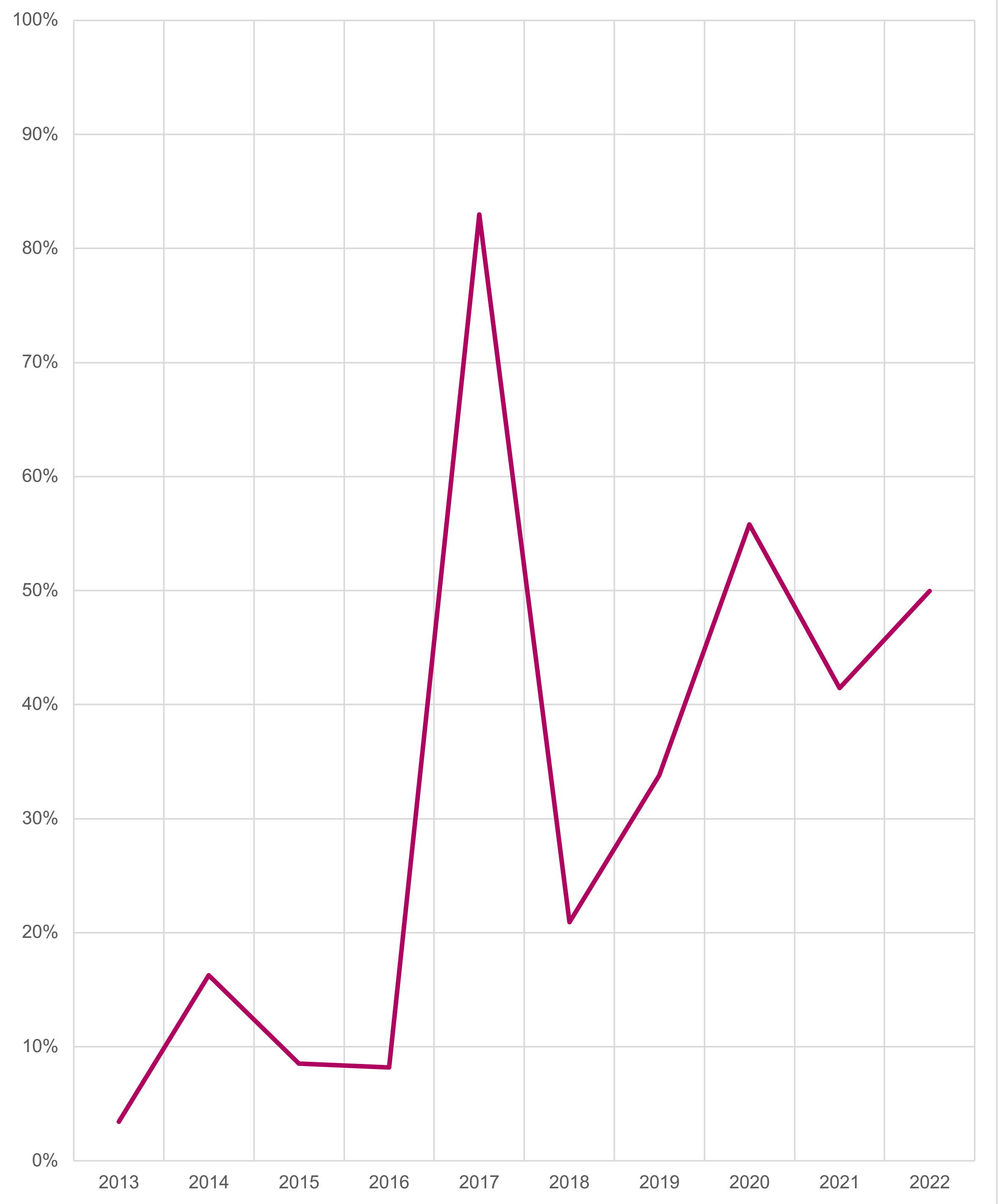
Market conduct: a focus on AML

A consistent message from regulators – but it's harder for firms to execute

In 2023, AML and sanctions risk management will be more fraught than ever.

UK regulators are highly focused on this area, as illustrated by their substantial and sustained levels of financial crime enforcement actions which now make up at least half of their total fines.

Total GBP FCA/PRA fines, financial crime as % of total, by calendar year



Nothing's changed in the UK regulators' key messaging: that financial crime (including AML and sanctions) are key risks, and that firms should manage them holistically, recognising the substantial overlap in the controls needed for the various financial crime risks.

But this will prove ever more challenging for firms.

UK AML reforms, postponed perhaps by UK Government ructions, should get back on track in 2023. These will produce increasing divergence between UK and EU requirements, with the EU full steam ahead on its own AML regulatory consolidation and reform agenda.

And sanctions have proliferated as geopolitical tensions intensified (in particular the Ukraine crisis). Accompanying rapid-fire UK regulatory reforms are producing new compliance headaches for firms. These will persist into 2023.

Firms that fall short of regulatory expectations will face the long tail of enforcement risk. And in this challenging environment, it is growing more difficult to avoid becoming lowest-hanging fruit for investigators.

Sanctions

2022 saw a proliferation of sanctions addressing geopolitical tensions, in particular the Ukraine crisis, affecting a wide range of economic activities including energy (accompanied by a price cap), shipping including maritime insurance, and various financial instruments and investments, and various commodities. These have created significant compliance challenges for financial services firms grappling with the sanctions themselves and the various general licences (containing exemptions) including those for payments to UK insurers and service fees for bank accounts.

The FCA responded in particular to the impact on funds by making rules allowing funds to establish "side pockets" to isolate sanctioned assets.

These sanctions show no sign of abating in 2023 and so will cause continuing headaches for compliance teams, especially those supporting EU and other cross-border businesses to which multiple jurisdictions' sanctions regimes may apply.

The UK position may become more fluid given that the Economic Crime (Transparency and Enforcement) Act 2022 introduced a streamlined process to impose sanctions on an expedited basis. Plus this Act raised the stakes by effectively enabling OFSI to impose strict civil liability for sanctions breaches (penalties can be considerable). And the Act now requires OFSI to publish reports on its monetary penalties and where it has not imposed penalties but nonetheless is satisfied that breaches have occurred – effectively a "naming and shaming" power which could have real reputational consequences. Finally, cryptoasset exchange providers and custodian wallet providers are now brought within UK sanctions regimes and must now comply with enhanced sanctions reporting obligations.

To bolster compliance efforts, the UK Government is focusing on improving the central collection of reliable information on beneficial owners of assets. The Economic Crime (Transparency and Enforcement) Act 2022 creates a new register of overseas owners of UK property, to be operated by Companies House. And the UK Government's Economic Crime and Corporate Transparency Bill aims to improve the integrity and quality of data on the Companies Register (as noted above).

Into 2023, firms should maintain their focus on, and resourcing of, sanctions controls to ensure compliance and mitigate later enforcement risk. Firms that combine their sanctions, AML and other financial crime controls work into a holistic assessment and improvement projects may enjoy the benefit of some helpful synergies and tailwinds – noting the regulators' messaging that firms should manage these risks holistically and the substantial overlap in the controls that are required.

UK AML reforms

The MLRs requirement to report material discrepancies between KYC information and information held by Companies House on an ongoing basis will take effect on 1 April 2023. And by September 2023 the UK's 2022 amendments to the Money Laundering Regulations (MLRs) will come fully into force. These amendments:

> Give AML/CTF supervisors and UK AML authorities wider gateways to share information and intelligence.

> Adopt the globally standard definition of Proliferation Financing.

> Extend CDD and Companies House registration (and discrepancy reporting) requirements to cover all business types including trust and company service providers and limited liability partnerships.

> Implement the "travel rule" for cryptoassets.

The Economic Crime (Transparency and Enforcement) Act 2022 creates a new register of overseas owners of UK property, to be operated by Companies House. It also strengthens the system of Unexplained Wealth Orders (UWOs).

The UK Government's new Economic Crime Levy on MLRs-regulated businesses will first fall due in the 2023-24 reporting year. This Levy will help fund the Government's AML efforts.

The UK Government's Economic Crime and Corporate Transparency Bill is likely imminently to become law largely in its present form. At least some of its provisions could take effect during 2023. The Bill:

> Aims to improve the integrity and quality of data on the Companies Register including by requiring the Registrar to verify identity (backed by criminal liability for negligently misleading the Registrar and civil penalties powers). This will in turn substantially increase compliance cost and burden for financial services firms interacting with the Companies Register.

> Addresses more business types. It would tighten registration, transparency and activity requirements for limited partnerships, and would extend criminal confiscation and civil recovery powers to cryptoassets.

> Intends to reduce obstacles to information sharing. It would enable businesses in certain situations to share information more easily to counter economic crime, by disapplying civil liability for breach of confidentiality in those contexts. And it would enable the NCA's Financial Intelligence Unit (FIU) to obtain AML/CTF information from a business even where the business has not first made a Suspicious Activity Report (SAR).

> Would expand the types of case in which businesses can deal with clients' property without having to first submit a Defence Against Money Laundering (DAML) SAR.

The Government is likely to respond in 2023 to HMT's 2021 consultation on the UK AML regime – a response perhaps delayed by UK Government instability but likely now imminent given that the FATF is due in 2023 to conduct its 5th year follow-up of its - largely positive - 2018 mutual evaluation of the UK's AML/CTF regime. The content of the response is difficult to predict given the wide-ranging nature of the consultation: it reviewed the systemic functioning of the regime including regulators and their supervisory and enforcement approach, and considered possible regulatory reform including to support risk-based decision making particularly around CDD, support adoption of new technology to improve controls, maximise the utility of Suspicious Activity Reports (SARs), prevent entry of bad actors into the regulated sector, and give sector-specific guidance for industry participants.

These actual and proposed reforms will make important additional resourcing demands on firms:

> Additional KYC/CDD resource will be needed to meet firms' obligations to support the expanded role of the Companies Register.

> Additional compliance resource will be needed to request – and respond to requests – for information to counter economic crime via the disapplication of civil liability for breach of confidence. These requests may be nuanced and involve considerable commercial sensitivities.

> Additional compliance and legal resource will be needed to respond to the NCA FIU's use of wider information gathering powers.

In the meantime, regulators and regulated firms are attending to concerns about money laundering and financial crime concerns relating to funds advanced under government-supported Covid-19 loans. And UK regulators (including HMT) are engaged in questions of appropriate cryptoasset regulatory reform. The focus is presently on systemic safety and soundness, but some strengthening of cryptoasset AML regulation is possible in the medium term.

EU AML reforms – and EU-UK divergence

The EU is planning a package of AML reforms including uniform regulation and a single EU AML authority (the AMLA), as well as a recast revised Wire Transfer Regulation (WTR) prioritised in the view of the need for a cryptoasset "travel rule" to ensure transfer traceability. Originally slated for adoption in 2022, we now expect these reforms to be adopted in 2023. The full regime would come into force three years later, giving the AMLA time to prepare technical standards. The regime would among other things:

> Widen the scope of the regime including to cover all cryptoasset service providers, crowdfunders, and mortgage and consumer credit firms.

> Strengthen internal controls requirements, including individual accountability and group-wide (and parent) measures.

> Clarify Customer Due Diligence (CDD) measures, including identification and verification, electronic identification, and use of standard datasets.

> Streamline the identification of high-risk third countries.

> Clarify how entities can rely on third party CDD.

> Harmonise suspicious activity reporting.

> Give clarity on data protection.

> Cap cash payments at EUR10,000.

> Revise beneficial ownership rules.

> Implement cross-border connection of national bank and payment account registers.

The EBA expects in 2023 Q2 to issue guidelines on de-risking; and in 2023 Q4 to issue guidelines on policies, procedures and controls to support the implementation of restrictive measures, revised guidelines on money laundering and terrorist financing (ML/TF) risk factors, revised guidelines on transfers of funds, and revised guidelines on risk-based supervision.

As we observed last year, the UK and EU are both committed to FATF's standards so their AML efforts will broadly align, but it's the specifics that could trip up firms – so firms should engage in granular review and adjustment of their processes. Over time we may see divergence between the EU and UK in relation to the firms falling within scope, requirements applying to group entities, criteria for EDD/SDD, digital identification requirements, when a firm may rely upon outsourced CDD, balancing information gathering and data protection, and large cash payments.

Putting consumers first: Policy and Outlook

The FCA is committed to setting clearer and higher expectations for the standards of care and customer service that firms give to consumers. The FCA has set itself demanding metrics against which to measure future success and is focused on becoming more data-led and agile, intervening earlier to prevent harm

With the advent of the new Consumer Duty, the FCA expects firms to consider, whether they are contributing to good customer outcomes (including for those with characteristics of vulnerability) through their activities at every stage of the customer journey.

Policy

FCA focus on consumer wellbeing and protecting vulnerable customers has continued throughout 2022:

> Continued work following the publication in 2021 of guidance on the fair treatment of vulnerable customers resulted in further guidance from the FCA on the areas where it has not yet seen the improvement it expects.

> The FCA's latest Financial Lives research suggests that 47% of UK adults now have characteristics of vulnerability, and 24% of all UK adults now have low financial resilience, emphasising the importance of firms embedding the FCA recommendations.

> The importance of financial inclusion is emphasised and the FCA will be monitoring closely to ensure that measures that it puts into place (such as the consumer duty) do not prompt risk aversion in firms (or even the withdrawal of products for difficult to reach groups).

Particular emphasis is also placed on the current cost of living crisis. The FCA has set out its expectation that firms reflect on the likely impact of this on consumers and proactively take the necessary steps to support them and mitigate harm.

The FCA's *Consumer Investments Strategy* remains a focus and the FCA reports having placed restrictions on twice as many firms in the investment market compared to last year, as part of its strategy designed to prevent harm in the consumer investment market.

The FCA of course expects consumers to take responsibility for their choices and decisions. Nevertheless it emphasises that consumers' ability to do so may be limited, not least because they don't have access to the information they need to make informed decisions at the time they need it.

With this in mind, new rules are coming into force which will strengthen financial promotions rules for high risk investments and the firms approving financial promotions (see further below).

Outlook

Flowing from the FCA's pivot to an outcomes based regulatory landscape, firms should expect greater emphasis on outcomes as a measure of compliance, and as a basis for new regulation. This will be seen most prominently in the work undertaken to implement the consumer duty (see further below) as the FCA works with firms to identify examples of good and poor practices. The FCA has highlighted its commitment to making use of its supervisory powers to take quick and effective action to address harm where it sees poor practice, including in cases where products or services may not be regulated.

Given the deteriorating economic context and the cost-of-living crisis the FCA will also continue to review the Consumer Investments Strategy (with a report on progress in 2023) and will reinforce its work where it identifies growing consumer harm.

Further resources

Read: our report on the FCA's 2022 strategy and Business Plan

Explore: Our Consumer Duty webpage

Putting consumers first
Financial promotions

The enhanced financial promotions requirements – some of which apply from 1 December 2022 – are relevant to private wealth managers and asset managers making financial promotions for relevant high-risk investments to retail clients, and to firms who approve the relevant financial promotions.

Under the new rules, the FCA has **"rationalised" high-risk investments into two categories**: (i) restricted mass market investments (RMMIs), which include non-readily realisable securities (eg unlisted securities), and peer-to-peer agreements and portfolios, and (ii) non-mass market investments (NMMIs), which captures non-mainstream pooled investments (such as units in unregulated collective investment schemes or LTAFs), securities issued by SPVs and speculative illiquid securities (such as mini bonds).

The new rules introduce **"frictions" into the customer journey** where RMMIs and NMMIs are offered to retail investors. The precise requirements are complex and depend on whether the product being promoted is an RMMI or NMMI. The enhancements to the customer journey include:

> New risk warnings and risk summaries (with specific wording prescribed, dependent on what product is being promoted and certain other factors);

> Certain promotions of some high-risk investments being limited to high net worth, certified, self-certified or "restricted" investors only;

> A ban on "inducements" (such as "refer a friend" or new joiner bonuses);

> New 24 hours cooling off periods applicable to certain promotions; and

> Changes to appropriateness assessments to avoid retail investors "gaming", or being coached for, the relevant questionnaires.

Firms approving financial promotions are subject to new guidance, including competency and expertise requirements in respect of the type of investment being promoted. Approvers will also be required (amongst other enhancements) to take a more active role in ensuring that promotions remain complaint for as long as they are being used, rather than just on day 1. This will require approvers to consider whether any change has occurred which results in the promotion no longer being clear, fair and not misleading, "including consideration of the ongoing commercial viability of the proposition being described in the promotion". For these purposes, the FCA expects approvers to obtain three-monthly attestations of "no material change".

Timing

The enhanced requirements on risk warnings and risk summaries apply from 1 December 2022.

The other enhancements to the financial promotions regime apply from 1 February 2023.

Looking ahead

The FCA has set out its plans for a new "gateway" for firms which approve financial promotions for unauthorised persons. Under the proposed rules, firms that want to continue to be able to approve promotions will need to apply to the FCA for permission to do so. These new rules are expected to be finalised in the first half of 2023.

There may be further FCA work in 2023 to consider the categorisation of certain products (eg different types of P2P agreements). Further the FCA makes it clear that cryptoassets are high-risk investments, and that promotions of qualifying cryptoassets will become subject to requirements which are consistent with those applicable to RMMIs in the future, once the regulation of cryptoassets comes within the FCA's remit.

Further resources

Read: Our client note on the enhancements to the financial promotions regime

Spotlight on the Consumer Duty

With implementation plans for the Consumer Duty finalised by the end of October 2022, asset managers be looking ahead to the next phase of their implementation journeys.

Firms that are proactive at this early stage will more confidently meet the FCA's deadline for implementation and be better placed to meet the Duty as part of their BAU operations post go-live.

The FCA's new Consumer Duty heralds the largest shift in a decade in the FCA's expectations around firm's treatment of retail customers, and will capture activity by retail and wholesale firms.

The Duty's outcomes-focused approach is intended to give firms more flexibility to tailor implementation to meet the demands of their businesses, and to apply more readily to future technological and market developments than a more static, rules-based regime.

The FCA intends to measure the success of the Duty by measures that include monitoring FOS decisions and feedback gathered through its Financial Lives Survey, and will develop additional metrics over time.

Next steps

Scoping: The focus for firms should now be on putting their implementation plans into action – and the first step will be on determining to what extent the new rules apply to their products and services.

Asset managers will need to consider this carefully in light of the FCA's expectation that firms "look through" to the end retail investor and assess whether they can determine or materially influence outcomes for them – even if there is no direct customer relationship. The Duty will also cover the provision of services, such as portfolio management.

Gap analysis and product review: Once scoping concludes, firms will need to understand what uplifts to existing policies and procedures will be needed to comply with the Duty. Manufacturers are also expected to complete reviews of all their products by April 2023, to enable information relevant to the products and services, and price and value, outcomes to be communicated to distributors in good time.

Monitoring and governance: The FCA will expect firms to clearly articulate their plan for monitoring compliance with the Duty going forward, and to establish an effective ongoing governance framework (the role of MI and data will be key). Firms' cultures will need to evolve to accommodate the higher standards within the Duty and extensive internal training of staff at every level will be required.

Interaction with the FCA

The FCA has committed to engaging with firms and being more open and agile in responding to the market and promoting good practice. In return, firms are expected to engage with the FCA, particularly if, as a result of their work implementing the Duty, they are considering withdrawing or restricting access to any products or services in a way that will significantly impact vulnerable customers or overall market supply.

The FCA reached out to some firms promptly upon expiration of its October 31 soft deadline for board sign off of implementation plans, requesting details of their implementation planning. Firms should expect ongoing dialogue with the FCA as the Duty beds down.

Looking ahead

The full set of rules will apply on 31 July 2023 to new and existing products that are open to sale or renewal. The implementation deadline for closed products or services arrives one year later on 31 July 2024.

The July 2023 deadline is challenging. The FCA has noted that most firms appear to be well on track, and sees no need to move the deadlines again. Helpfully the FCA has nevertheless reiterated its intention to remain pragmatic in its oversight of implementation.

Further resources

- **Explore:** Our Consumer Duty webpage where you will also find our Consumer Duty Podcast series
- **Read:** The Final FCA Consumer Duty Rules: key focus areas for asset managers
- **Watch:** The Consumer Duty: the Final Rules – your implementation journey begins
- **Watch:** Our Consumer Duty webinar – Asset managers, wealth managers and private banks
- **Watch:** The Consumer Duty: Scoping and setting up implementation for success

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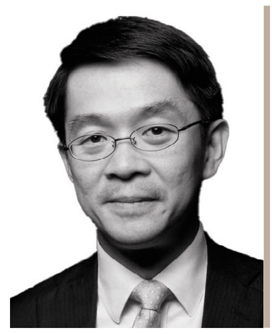

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