

FINANCIAL SERVICES REGULATION

Exchange – International

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Introduction

Welcome

DLA Piper's Financial Services International Regulatory team welcomes you to the 43rd edition of Exchange – International, our international newsletter designed to keep you informed of regulatory developments in the financial services sector.

This issue includes updates from the EU, as well as contributions from the UK, Spain, France, the US and Mexico, plus International developments.

In this edition, In Focus provides practical insights regarding the legal position on e-signatures under English law.

We also analyse the developments in the UK payments sector, including: the findings of the Payment Systems Regulator's Interim Report regarding merchant acquiring services; HM Treasury's consultation on the future of the UK payments landscape; and the Financial Conduct Authority's work aiming to strengthen customer protections at payment firms. In addition, we discuss the UK government's new proposed rules concerning the marketing of cryptoassets and we provide insights on the Climate Financial Risk Forum's latest guide on climate-related financial risk management.

In the EU, we examine the European Commission's recent notice to stakeholders post-Brexit, which sets out the Commission's expectations of firms in light of the expiry of the Brexit transitional period at the end of this year. We also discuss the European Banking Authority's thematic report on the impact of COVID-19 on the EU banking sector.

Other topics covered in this edition include Spain's new rules on advertising of banking products and services; recent guidance allowing US banks to provide cryptocurrency custody services; and Mexico's new fintech framework. We also look at international developments, such as the Basel Committee's new proposed rules on principles for operational risk and operational resilience.

Your feedback is important to us. If you have any comments or suggestions for future issues, we welcome your feedback.

The DLA Piper Financial Services Regulatory Team
October 2020.

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UK



Payment Systems Regulator – interim report

On Tuesday, 15 September 2020, the Payment Systems Regulator (PSR) presented its Interim Report with their conclusions thus far. They have requested that any comments on their findings and proposals be provided by 5pm on Tuesday, 8 December 2020.

Interim report – summary of key findings

Small and medium-sized merchants (annual card turnover up to GBP10 million)

The PSR found that the largest acquirers: (1) Barclaycard; (2) Elavon; (3) Global Payments; (4) Lloyds Bank Cardnet; (5) Worldpay (Largest Acquirers), and First Data, dominate the market for the provision of card-acquiring services to small and medium-sized merchants of all sizes.

The following areas of concern were raised by the PSR for small and medium-sized merchants:

- Acquirer and ISO pricing creates significant search costs for merchants due to the absence of published prices and the complexity of comparing prices.
- Indefinite duration of merchant contracts for card-acquiring services fails to provide a clear trigger point for merchants to consider searching for another provider and switching.
- Acquirer and ISO POS terminal contracts – long initial terms of three to five years and automatic renewal combined with a lack of parity in term length between contracts for card-acquiring services and POS terminals presents a barrier to switching to a different provider.

Large merchants (annual card turnover over GBP10 million)

The PSR found that the Largest Acquirers, Adyen, AIB Merchant Services and First Data dominate the market for the provision of card-acquiring services to large merchants, serving merchants who sell through multiple channels.

It was found that merchants with an annual card turnover above GBP50 million can access information about providers and assess their requirements and are therefore well served by card-acquiring services, while merchants with an annual card turnover between GBP10 million and GBP50 million face the same restrictions as small and medium-sized merchants.

Scheme fees and IFR savings

The PSR found that their current analysis indicates that, for merchants in all turnover groups, scheme fees paid by acquirers to Mastercard and Visa for scheme services were passed through by acquirers in full.

In respect of the available Interchange Fee Regulation (IFR) savings made by acquirers, they found that the majority were passed through to merchants and that the estimated benefit of savings to these merchants was around GBP600 million in 2018. However, it should be noted that this was because merchants with interchange fee plus pricing received full pass through and they accounted for around 77% of the overall value of transactions in 2018.

Proposals

The following actions have been proposed to remedy the key issues identified above:

- Acquirer and ISO pricing – enabling or enhancing tools to facilitate price comparisons for merchants and requiring acquirers and ISOs to provide pricing information in an easily comparable format.
- Indefinite duration of merchant contracts for card-acquiring services – all contracts for card-acquiring services having an end date.
- Acquirer and ISO POS terminal contracts – limiting the length of POS terminal contracts; ending automatic renewal; and linking the contracts for card-acquiring services and POS terminals.

FCA publishes findings of review into relending by firms that offer high-cost credit

On 6 August 2020, the Financial Conduct Authority (FCA) published a report setting out review findings of relending by firms in the high-cost lenders portfolio. The FCA also commissioned a study by PricewaterhouseCoopers (PwC) as an aid to understand repeat borrowing in the high-cost credit market.

Background

In March 2019, the FCA issued a Portfolio Strategy letter highlighting key risks that firms within the high-cost lenders portfolio pose to their customers or markets. From this review, a high volume of relending was identified as one of the key ways consumers may be harmed. Subsequently, the FCA prioritised diagnostic work to better understand the motivation for, and impact of, relending on both consumers and firms.

The new findings apply to high-cost lender portfolio firms offering the following products:

- guarantor loans
- high-cost short-term credit (HCSTC)
- high-cost unsecured loans aimed at subprime customers
- home-collected credit (HCC)
- logbook loans
- rent-to-own (RTO)

Findings

Below are the key takeaways from the FCA's findings:

Relending and customer outcomes – firms should ensure that relending leads to positive customer outcomes and does not cause harm. For example, the FCA noted that a number of high-cost short-term credit (HCSTC) firms enter into administration as a result of liabilities for complaints, depicting the consequences for firms that fail to adequately assess affordability or relend in a way that is sustainable for their customers. HCSTC customers are more likely to be vulnerable, have low financial resilience and poor credit histories,

therefore firms are not to encourage refinancing of credit agreements where the customer's commitments are not sustainable. Firms are also expected to only agree to refinance if they reasonably believe that it is not against the customer's best interests to do so.

Increasing levels of debt and repayments – the level of debt and repayments can increase significantly, to the point where it is no longer sustainable. The FCA reminds firms of the Dear CEO letter from October 2018, sent to all HCSTC firms. Firms must not encourage a customer to refinance a regulated credit agreement if the result would be the customer's commitments becoming unsustainable. The FCA suggests that additional borrowing should not be used as a debt management solution.

Relending, profitability and consumer harm – relending accounts for a high proportion of business and drives profitability in many firms, which gives rise to customer harm. The FCA reminds firms of their requirement to lend responsibly and to be mindful that repeat lending has the potential to lead to poor customer outcomes.

Marketing activity and customer behaviour – firms' marketing activity can adversely influence customer behaviour. The FCA expects to see marketing content contain all relevant information that is sufficient to support customers to make informed decisions regarding additional borrowing.

Marketing materials – should be clear, fair and not misleading. Firms should not exploit customer bias to adversely influence customer behaviour and cause harm. The FCA asks firms to review their marketing materials and make any necessary amendments to ensure they are not misleading. Additionally, firms should make sure to meet specific requirements for financial promotions as set out in CONC 3.

Online account messages – certain online account messages encouraging customer to reborrow could constitute marketing and must not restrict access to customer accounts. The findings highlighted that some firms do not consider online account activity offering additional credit to customers to constitute marketing. The FCA clarifies that any communication offering additional credit to a customer constitutes marketing and is subject to both FCA requirements on financial promotions as well as data protection laws around privacy.

Refinancing loans – customers should be able to make informed borrowing decisions. The FCA notes that home-collected credit firms should make sure to explain different relending options and associated costs to customers before they take additional borrowing, due to the more vulnerable and financially stretched customer base.

Early settlement charges – should not be charged when a customer refinances their loan. When firms make an early settlement charge as part of a refinancing, the charge is added to the new loan and so interest is charged on this charge. This means that if the credit is refinanced several times, the costs compound. The FCA expects firms to stop requiring or encouraging the borrower to serve the statutory notice when refinancing immediately.

Next steps

The FCA expects firms to review their relending operations in the light of the findings above and as a result, make any necessary changes.



HM Treasury launches consultation on what's next for the UK payments landscape

On 28 July 2020, HM Treasury published a Call for Evidence on the development of the UK payments landscape. This represents the first stage of a government review to ensure that the UK's payments landscape is fit for purpose.

The government wishes to identify opportunities, gaps and risks that need to be addressed in the future in order to ensure that the UK maintains its status as a country at the cutting edge of payments technology.

Government objectives

The Call for Evidence notes recent government initiatives in the payments landscape, including the creation of the Payment Systems Regulator (PSR) and bringing UK payment systems under formal regulation.

The development of the New Payments Architecture (NPA), the Bank of England's work in enhancing the Real Time Gross Settlement service and the Competition and Markets Authority (CMA) driving forward Open Banking are also listed in the Call for Evidence as significant achievements in the payments landscape to date.

The four broad aims of the government in respect to the payments landscape are to foster:

1. UK payment networks to operate for the benefit of end users, including consumers;
2. a UK payments industry that promotes and develops new and existing payment networks;
3. UK payment networks that facilitate competition by permitting open access to participants or potential participations on reasonable commercial terms; and
4. UK payment systems that are stable, reliable and efficient.

Opportunities and risks in the payments landscape

The Call for Evidence goes on to note that the payments landscape is evolving quickly and this presents new opportunities and risks. It highlights such opportunities and risks for the NPA, Faster Payments Scheme, Open Banking, new payment institutions/chains as well as cross-border payments and the development of cryptographically secure payment tokens.

New payments architecture

The Call for Evidence notes that the PSR is monitoring the delivery of the New Payments Architecture by Pay.UK. The PSR issued a Call for Input in January 2020, seeking views on how both the design and procurement of the new core infrastructure can support innovation and competition between different types of payments services and payment systems, and drive better outcomes for end users.

According to the Call for Evidence, the PSR plans to publish a policy statement setting out their regulatory approach to the NPA later this year. Alongside this, the Bank of England has set out its expectations for Pay. UK to ensure the new core infrastructure is robust, resilient and secure and that the migration to it minimises any risk of discontinuity or degradation in service.

The Call for Evidence does not ask industry any questions with respect to the NPA. Instead it notes that it will build in the PSR and Bank of England approach to the follow-up to the Call for Evidence.

Faster payments scheme

Faster Payments is a 24/7 real-time payments system. Speeding up payments has had wide benefits for the UK economy. Consumers and businesses can transfer funds in real time with the certain knowledge that funds have been sent and received.

The Call for Evidence notes that the lack of scheme rules to resolve disputes and assign liability when a payment goes wrong may have inhibited the use of the Faster Payments Scheme in widespread person-to-business payments. The lack of these rules is compared to the comprehensive rules in international card payment schemes which have clear rules on chargebacks, dispute resolution and the assignment of liability.

Open banking

The Call for Evidence also notes that the CMA has set out the final steps for the Open Banking journey. Though considerable work has been undertaken on the sharing of data for account information services, the development of payment initiation services that make use of open banking data has been more limited. The Call for Evidence asks what is required to enable payment initiation services to take off in the UK in a way that is safe and secure for the consumer.

New payments firms and payments chains

Over the last ten years, new payment services firms, including non-bank firms have entered and transformed the payments landscape. In many cases these have used new technology to provide new services and functionality, taking over some of the functions previously performed by other parts of the payment network in the UK.

The Call for Evidence notes that some firms fall outside the regulatory perimeter, such as pass-through digital wallets on mobile devices or gateway providers providing technical solutions for e-merchants to accept payment.

Cross-border payments

Cross-border payments are essential to the functioning of a modern outward looking global economy. Cross-border payments may be processed via long chains between financial institutions operating in different currencies and each stage imposes costs. Smaller firms offering money generally rely upon payment accounts provided by banks, which makes them vulnerable to these accounts being withdrawn or denied.

The G20 has made enhancing cross-border payments a priority. Faster, cheaper, more transparent and more inclusive cross-border payment services would deliver widespread benefits for citizens and economies worldwide, supporting economic growth, international trade, global development and financial inclusion.

The Call for Evidence asks about future trends expected in cross-border payments in the next ten years. The government also asks what the role will be for governments, regulators and industry in responding to these trends.

Cryptoassets

Cryptoassets, including stablecoins (cryptoassets that seek to maintain a stable value in relation to a reference asset, such as GBP or USD) is another important area of innovation.

In its March 2020 Budget, the government set out two commitments relating to cryptoassets; firstly, consulting on bringing the promotion of cryptoasset activities into regulation and secondly, consulting on the regulatory approach to global stablecoins.

The government is not seeking evidence on these areas through this Call for Evidence. You can read about the separate government consultation elsewhere in this publication.

Next steps for the consultation

The Call for Evidence is open for 12 weeks and closes on 20 October 2020.

The government will set out next steps following a review of the evidence obtained.

UK government consults on financial promotions regime and cryptoassets

On 20 July 2020, HM Treasury published two consultations proposing amendments to the UK regulatory framework for approval of financial promotions and with respect to cryptoasset promotions. Overall, the consultation papers propose important changes to the way unauthorised persons communicate financial promotions more generally and also specifically with regard to cryptoassets.

Background: FSMA financial promotions regime

A financial promotion is an invitation or inducement to engage in investment activity. The communication of financial promotions is governed by the Financial Services and Markets Act 2000 (FSMA). More specifically, section 21 of FSMA provides that an unauthorised person must not communicate a financial promotion, except where that promotion is approved by an authorised person or the communication is otherwise exempt.

The FSMA Financial Promotions Order (FPO) provides for certain exemptions to the section 21 restriction; for example, in cases where the recipient is an institutional or sophisticated investor.

The financial promotions regime applies in relation to certain “specified investments,” such as securities like shares and bonds. It also covers cryptoassets that function in a similar manner to securities (so-called security tokens). However, a number of cryptoassets fall outside the financial promotions framework, which means that they may be promoted to investors (including retail persons) without the relevant safeguards in place for security tokens.

Consultation on financial promotions approval regime

Currently, any authorised person may approve financial promotions for the purposes of section 21 FSMA. The first consultation seeks to change this by introducing a regulatory gateway that aims to increase Financial Conduct Authority (FCA) oversight in this area. In particular, according to the government’s proposal, an authorised firm that wishes to be able to approve financial promotions must first obtain the consent of the FCA to be able to provide such a service specifically.

The consultation discusses the various ways that such a requirement could be introduced in the current framework. For example, the “approval of financial promotions communicated by unauthorised persons” could constitute a new regulated activity under FSMA for which a Part 4A permission would be specifically required. This means that not every authorised person will be able to approve financial promotions of unauthorised persons, but only those that have specific FCA permission to do so.

Consultation on financial promotions concerning cryptoassets

The second consultation aims to bring into scope of the financial promotions regime certain cryptoassets that are currently unregulated, but nevertheless have similar characteristics to regulated cryptoassets, such as security tokens. According to the government, this gap in regulation exposes consumers to “unacceptable levels of risk.” The consultation proposes to add to the list of controlled investments which are subject to the financial promotions regime a new category of qualifying cryptoassets.

A qualifying cryptoasset would be defined as “any cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology and which:

- is fungible;
- is transferable or confers transferable rights, or is promoted as being transferable or as conferring transferable rights;
- is not any other controlled investment as described in this Part;
- is not e-money within the meaning given in the Electronic Money Regulations 2011; and
- is not currency issued by a central bank or other public authority.”

According to the consultation, the majority of so-called stablecoins that do not already qualify as e-money or security tokens would be caught under this new category of qualifying cryptoassets.

The new regulated category would only cover cryptoassets that are both fungible and transferable. This would exclude, for example, cryptoassets used within a closed system where the only redemption option is via the issuer, rather than transfer to other users. This means that arrangements such as a blockchain supermarket customer loyalty scheme which uses tokens analogous to loyalty points would fall outside the scope of the financial promotions regime.

The consultation also proposes to add a new FPO exemption to allow vendors that merely offer to accept cryptoassets in exchange for their goods or services, and buyers that merely offer cryptoassets to pay for goods or services in the same manner as they would use fiat currency, to continue doing so without needing to comply with the financial promotions restrictions. The new exemption would provide that “the financial promotion restriction does not apply to any communication which merely states that a person is willing to accept or to offer qualifying cryptoassets in consideration for the supply of goods or services.”

The consultation closes on 26 October 2020, and we note that it will affect large numbers of cryptoasset service providers who deal with cryptoassets, including payment tokens such as bitcoin and ethereum, in the UK. The existing definitions around what constitutes a “financial promotion” are broad and we will be assisting our clients with understanding the potential consequences as the FCA looks at expanding the regulatory perimeter to cover otherwise unregulated cryptoassets in these respects.

FCA publishes draft guidance to firms on maintaining access to cash for customers

On 16 July 2020, the Financial Conduct Authority (FCA) published draft guidance setting out its expectations for banks, building societies and credit unions when considering closing branches or ATMs, or converting a free-to-use ATM to pay to use.

Background

As cash use continues to decline due to the COVID-19 pandemic, the draft guidance sets out the FCA's expectation that firms should carefully consider the impact of a planned closure or conversion on their customers' everyday banking and cash access needs (this includes withdrawals, deposits and other cash-related branch services such as cheque cashing). This draft guidance also sets out the FCA's expectation that firms put in place alternative access arrangements.

The proposal

In the draft guidance, the FCA expects firms to conduct analysis of the needs of customers currently using the sites, the impact of the proposals, and alternatives that could be put in place if they implement the proposals. The FCA expects to be provided with a clear summary of the results of this analysis.

Additionally, if a firm decides to progress the proposals, they would be expected to clearly communicate information about proposed closures or conversions to their customers no less than 12 weeks before a proposed closure or conversion would be implemented.

The guidance also sets out the FCA's expectation that firms consider putting in place alternative access arrangements where it is reasonable to do so, for example:

- sharing services with other providers;
- providing mobile banking hubs or cash delivery services;
- commissioning a free-to-use ATM; or
- supporting customers to use digital channels.

Next steps

The FCA welcomed comments from stakeholders on the draft guidance until Thursday, 30 July.



FCA publishes consultation on extending implementation deadlines for the certification regime and conduct rules

On 17 July 2020, the Financial Conduct Authority (FCA) published Consultation Paper 20/10 proposing an extension to the deadline for training staff on the Conduct Rules and reporting Directory Person data to 31 March 2021. Extending these deadlines will provide extra time for FCA solo-regulated firms that have been affected by the COVID-19 pandemic.

The FCA will still publish details of Certified Persons at FCA solo-regulated firms on the Financial Services Register from 9 December 2020, as firms submit this data. The FCA encourages firms to submit the data before March 2021, to the extent they are capable of doing so.

Treasury extension

The FCA consultation comes at a time when Her Majesty's Treasury has laid a statutory instrument before Parliament to delay the deadline to certify individuals subject to the Certification Regime until 31 March 2021. This delay will give firms significantly affected by the COVID-19 pandemic extra time to make the changes they need.

To give the industry certainty, the FCA decided to start this consultation process alongside the Parliamentary process, to enable the FCA to finalise its policy position as soon as possible.

Senior Manager and Certification Regimes (SMCR)

The majority of FCA solo-regulated firms (i.e. firms that are not also regulated by the Prudential Regulation Authority) became subject to the SMCR from 9 December 2019. From that date, these firms had to comply with the requirements of the Senior Managers Regime and individuals performing Senior Manager Functions and Certification Functions became subject to the Conduct Rules.

As part of a staged go-live of the requirements of the SMCR, solo-regulated firms were given 12 months until 9 December 2020 to assess the fitness and propriety of certified staff. Firms were also given until 9 December 2020 to submit information about certified and assessed staff such as non-executive directors

(together, Directory Persons) for inclusion on the Financial Services Registers and provide tailored training to all other employees, except ancillary staff, on the Conduct Rules.

The FCA recognises in the consultation paper that the COVID-19 pandemic means that some firms need extra time to meet these obligations. In some firms, both people and financial resources have been diverted to dealing with COVID-19-related challenges. Some managers and key personnel have been furloughed, which may impact the availability of decisionmakers and the delivery of new systems and processes to support implementation.

Training providers have also postponed courses, which could make it difficult for some Certified Staff to complete the training they need to enable firms to properly assess whether they meet the standards for certification. Plans for Conduct Rules training and culture change programmes may also have been affected.

FCA consultation 20/10

The FCA proposes in its consultation that, for FCA solo-regulated firms, the deadline for the following requirements be extended from 9 December 2020 to 31 March 2021:

- the date the Conduct Rules come into force, for staff who are not Senior Managers of Certified Persons;
- the date by which relevant employees must have received training on the Conduct Rules; and
- the deadline for submissions of information about Directory Persons to the Financial Services Register.

The consultation also proposes updating references in the FCA rules in light of HM Treasury's statutory instrument.

The FCA notes that it expects that the majority of firms will not need to use this extension. If firms are able to complete certification assessments, Conduct Rules training and Directory Persons reporting by the original deadline, the FCA encourages them to do so.

The consultation closed on 14 August 2020.

FCA sends “Dear CEO” letter to payments firms on preventing harm to customers

On 9 July 2020, the Financial Conduct Authority (FCA) sent a “Dear CEO” letter to all UK payment services firms and e-money issuers (collectively, payment firms). The letter highlighted six key areas where the FCA has identified non-compliance by payment firms which harms consumers.

The Dear CEO letter was sent on the same day that the FCA published Feedback Statement 20/10 and new finalised guidance for payment firms in light of the issues presented by the COVID-19 pandemic.

The new guidance and Dear CEO letter both come at a time when the FCA had just allowed Wirecard Card Solutions Limited, the UK regulated firm associated with Wirecard AG in Germany, to re-commence issuing e-money and provide payment services, subject to the FCA’s ongoing monitoring and other restrictions.

Dear CEO letter

In the Dear CEO letter, the FCA reminded payment firms that they must continue to comply with the Payment Services Regulations 2017 and the Electronic Money Regulations 2011, as appropriate. In addition, payment firms must continue to meet the conditions of their authorisation as well as the FCA’s Principles for Businesses (PRIN) which was extended to apply to payment firms from 1 August 2019.

The FCA also commented on the market conditions for payment firms. The payments and e-money sectors have developed quickly, with an increasing number of firms and products entering the market. The FCA has expressed concern that some firms that are growing rapidly may be unprofitable as they seek to claim market share. According to the FCA, the COVID-19 pandemic may affect payment firms’ financial strength and the availability of their external funding at time when these firms are under competitive and market stress.

The FCA identified the following six areas where non-compliance with these obligations harms consumers.

Safeguarding

- All payment firms are obliged to ensure customer funds are appropriately safeguarded so that if the firm enters insolvency, customer funds are returned in a timely and orderly way.
- The FCA asks payment firms to review their safeguarding arrangements regularly and follow the new FCA guidance on safeguarding. The FCA will proactively be testing payment firms’ safeguarding arrangements.

Prudent risk management

- Payment firms must ensure they have adequate financial resources. In the Dear CEO letter, the FCA states that firms should continue to meet their own funds requirements at all times and have sufficient regulatory capital to be able to incur losses while remaining solvent. The FCA notes that it expects to see payment firms reviewing and remediating their prudential risk management, where appropriate.

Financial crime

- Combating and preventing financial crime is a key cross-sector priority for the FCA. During a recent supervisory review of the payments sectors, the FCA found that several firms were failing to take appropriate steps to manage their financial crime risks.
- Among the issues the FCA found are the following:
 - payment firms not having effective business-wide anti-money laundering risk assessments;
 - the absence of customer risk assessments or assessments with methodologies that did not include all relevant risk factors;
 - a lack of effective and risk-sensitive enhanced due diligence for high-risk customers; and
 - senior management and payment firms not having adequate oversight of agents, particularly when these agents operate overseas.



- In terms of actionable items, the FCA asks payment firms to be aware of the financial crime risks inherent within their businesses – including risks associated with innovative products, unusual or agency-type business models and cross-border payments.

Financial promotions and consumer communications

The FCA recently reviewed a sample of firms' financial promotions for compliance with the rules and guidance in PRIN and chapter 2 of the Banking Conduct of Business Sourcebook (BCOBS) which has applied to payment firms since 1 August 2019, as applicable. The FCA noted several issues, including the following:

- claims about service and pricing that could not be substantiated;
- use of the FCA regulatory status in a promotional way, including inappropriate use of terms, such as "secure";
- inappropriate use of the term "free" when describing costs and charges relating to a currency conversion;
- promotions of e-money providing a misleading impression the firm is a "bank."
- The Dear CEO letter reminded payment firms they should ensure all their financial promotions are clear, fair and not misleading. The FCA will continue to undertake proactive reviews of financial promotions and will contact firms where they observe issues.

Governance and oversight

According to the FCA, a root cause of many payment firms' regulatory issues is inadequate governance and oversight. In particular, the FCA has observed that many

payment firms do not review their regulated processes with sufficient frequency in light of the applicable regulatory framework as their business changes or grows. The FCA requests that payment firms' senior management ensure that processes are reviewed regularly and governance functions are appropriately scaled to reflect the growth of that firm and the risks that apply to it.

Records management and reporting

The FCA has identified material inaccuracies and omissions in the information that payment firms have provided the FCA through regulatory reporting and responses to requests for information. The FCA has also found that, in most cases, record keeping of regulated processes is inadequate to demonstrate they have been conducted in a manner which meets the regulatory requirements.

The FCA has asked payment firms to ensure they maintain compliant records and supply the FCA accurate and clear information on time.

The Dear CEO letter concludes by the FCA stating that it will take action to address consumer harm, including in restricting regulatory permissions of payment firms or by cancelling permissions if it will protect consumers.

The Dear CEO letter also reminded payment firms with customers in the European Economic Area (EEA) that they must decide on their approach to their existing EEA customer contracts in light of the end of the Brexit transitional period on 31 December 2020.

FCA publishes findings from cryptoasset consumer research

On 30 June 2020, the Financial Conduct Authority (FCA) published a research note on cryptoassets consumer behaviour. The note is based on the results of quantitative research, commissioned by the FCA, to ensure its understanding of consumer behaviour and the areas of potential harm is accurate. It builds on the results of the FCA's qualitative research, published in March 2019, and forms part of the wider project of work being undertaken by the UK Cryptoasset Taskforce.

Highlights from the research:

- While the FCA research highlights a growing awareness of cryptocurrencies, ownership within the UK population remains low, at 3.86%.
- Most consumers seem to understand the risks associated with the lack of protections and high volatility of the product. However, the same level of knowledge was not demonstrable in relation to the technology underlying cryptocurrencies.

- Technical knowledge was higher among individuals who actually held cryptocurrencies.
- Currently, consumers tend to treat cryptocurrencies as a form of speculation, akin to gambling, rather than as a payment or investment.

In July 2019, the FCA consulted on banning the sale of certain cryptoasset derivatives to retail investors. The consultation closed in October 2019 and the results are awaited.



Latest Climate Financial Risk Forum guide released

On 29 June 2020, the Climate Financial Risk Forum (CFRF) published their guide to climate-related financial risk management.

Climate-related risks will affect the financial position of entities and will have a significant impact on the financial services sector. Climate change will prevent assets from delivering services, affect the value of assets, the cost and availability of insurance and the creditworthiness of borrowers.

In the last few years we have seen increased attention by key financial institutions and supervisors on developing a common understanding and approach to addressing climate-related financial risks and opportunities.

In the UK, the Climate Financial Risk Forum (CFRF) was launched last year and is co-chaired by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The objective of the CFRF is to build capacity and share best practice across financial regulators and the financial services industry to advance the sector's responses to the financial risks from climate change.

The CFRF agreed key priorities in enabling entities to develop an effective and robust approach to responding to climate-related financial risks and opportunities and established four working groups on the topics of: Risk Management; Scenario Analysis; Disclosures; and Innovation. Each working group was tasked with producing a chapter on their topic, which constitute the chapters of the guide.

- Risk management – by embedding climate-related financial risk into governance and risk management, an entity can make better informed decisions, build resilience and better respond to systemic shocks.
- Scenario analysis – by considering and modelling a range of potential climate-related scenarios, entities can better understand and manage future risks, while identifying the opportunities of transitioning to a decarbonised economy.
- Disclosures – by making effective climate-related financial disclosures, entities will improve transparency of material financial risks from climate change on their businesses, helping the market better assess the future value of assets.
- Innovation – by developing new approaches, products, services and policies an entity can better respond to the impacts of climate change and contribute towards a decarbonised economy.

The CFRF guide is complementary to existing frameworks and initiatives, such as the UN-supported Principles for Responsible Investment, Banking and Insurance and the Taskforce on Climate-related Financial Disclosures (TCFD).

High Court provides guidance on SIPP administrators' duties to execution-only clients

On 18 May 2020, the High Court delivered its judgement in *Russell Adams v Options SIPP UK LLP* regarding the potential liability of an execution-only Self-Invested Personal Pension (SIPP) provider to an investor whose underlying investment in the SIPP incurred significant losses.

Background

The main question for the Court to consider was whether the defendant, Options SIPP UK LLP (D), a SIPP provider and administrator, which operated on an execution-only basis, was liable to the Claimant investor, Adams (C), for the losses which C claimed he suffered as a result of entering into what he alleged was an unsuitable investment which C instructed D to hold within a SIPP wrapper.

Facts

C decided to invest his pension in a high risk non-standard investment via an execution-only SIPP held with D. C claimed that he transferred his pension to the SIPP and made the investment because of advice he received from an unregulated introducer firm, CLP Brokers (CLP). Ultimately the investment performed poorly, and C sued D to try to recover the value of his pension.

The following three grounds were raised by C:

1. Breach of section 27 of the Financial Services and Markets Act 2000 (FSMA): This section gives the Court discretion to unwind an agreement.
2. Breach by D of FCA Conduct of Business Rules (COBS) when accepting his execution-only business to open the SIPP and invest into the high-risk investment; and/or
3. D was vicariously liable for CLP's negligent advice to C about the investment, because it was in a joint enterprise with CLP.

Decision

All three of C's claims failed:

1. SECTION 27 FSMA

The claim under section 27 of FSMA was dismissed because the agreement in question was the establishment of the SIPP itself, and CLP was not performing a regulated activity in relation to the creation of his SIPP. CLP was not arranging or advising on (as the relevant regulation requires) opening the SIPP. Further, the fact that CLP was introducing C to D, and "steering" an investor to a specific SIPP provider was not enough to meet this test. It was relevant that C's instruction to D to invest occurred after the SIPP had been established and therefore after CLP's involvement had ceased.

2. COBS

The only applicable Rule was COBS 2.1.1 – that D was to act honestly, fairly and professionally and in accordance with the best interest of its client. C said that D did not act in his best interests, as it should have had a system in place to protect him (and thus have rejected his application to open a SIPP) when he sought to make an unsuitable investment, via an unsuitable introducer.

The court found that COBS 2.1.1 did not impose any such duty on D as an execution-only provider: there was a plain inconsistency between what C now said D should have done, and the terms of his contract with D. The judge decided that C knew the investment was high-risk and went ahead anyway, and that he should take responsibility for his decision and its consequences.

3. JOINT ENTERPRISE

The court found that even if CLP had made a negligent mis-statement, D did not know CLP was giving advice, and the parties did not have a common design, so there was no joint enterprise and no vicarious liability.

FCA launches consultation on strengthening customer protections at payment firms

On 22 May 2020, the Financial Conduct Authority (FCA) launched a Consultation on additional guidance for payment firms to strengthen the way they safeguard customer funds.

Following this Consultation, the FCA published Feedback Statement 20/10 and finalised guidance on 9 July 2020. On the same day, the FCA also published a further letter to CEOs of payment firms, on which you can read more elsewhere in this publication. This letter includes the guidance as amended in light of the responses to the consultation.

FCA focus on payments firms

The payments sector is a priority area for the FCA.

This Consultation is part of a broader programme of work that the FCA was planning on consulting on later this year. This Consultation has been brought forward due to the pressures the COVID-19 pandemic is placing on payment firms' finances.

This programme of work has involved the FCA identifying issues and problems with non-bank payments firms (being authorised payment institutions and e-money institutions) meeting the requirements of the Electronic Money Regulation 2011 and the Payment Services Regulations 2017 (the Regulations).

Customer money held at UK-authorised banks, building societies or credit unions are protected by the Financial Services Compensation Scheme (FSCS). If one of those firms becomes insolvent, the FSCS protects up to GBP85,000 per eligible depositor. Conversely, customer money held at payment firms is not protected by the FSCS. The Regulations do require payment firms to safeguard customer funds, either by segregating these funds from house monies or having in place appropriate insurance policies or guarantees.

In July 2019, the FCA set out these issues in a Dear CEO letter, stating that it had identified significant shortcomings in that payment firms had a poor understanding of which funds are "relevant" funds under the Regulations and should be segregated from house funds. The letter also noted that there were delays in segregating funds on receipt and that payment firms had failed to check that correct amounts are being segregated frequently enough via the reconciliation process.

Impact of the COVID-19 pandemic

According to the FCA, the Consultation was pushed forward as a result of the potential impact of the COVID-19 pandemic on payment firms.

The payments sector has been developing rapidly and there are an increasing number of firms entering the market. Some of these firms are relatively small fintechs with more limited access to capital than larger players.

The FCA notes that some payments firms are unprofitable in the early stages while they seek to grow market share and many also rely on investor funds to remain solvent in the short-term. Firms may also be facing decreased revenues because of COVID-19 and this might be affecting their ability to operate as well as their growth plans.

Accordingly, the FCA considered the guidance in the Consultation necessary to provide additional direction to payment firms to safeguard customer funds and also for these firms to put in place more robust plans for winding down, should a firm fail, so that customer funds are returned in a timely manner.

Content of the Consultation

1. SAFEGUARDING

a. Keeping records and accounts and making reconciliations

The FCA states that under no circumstances would it be acceptable for a payment firm to undertake a reconciliation of safeguarded funds less than once each business day. The FCA Consultation also notes that firms should carry out reconciliations as often as is practicable.

The FCA expects payment firms to notify the FCA should they fail to keep up-to-date records of relevant funds and safeguarded accounts.

b. Safeguarding accounts and acknowledgement letters

The segregated account that the payment firm holds at a bank should be appropriately designated in the account name with either “safeguarding” or “client.” Where the bank cannot make the necessary designation evident in the name of the account, the FCA expects the payment firm to provide evidence, such as a letter from the relevant credit institution or custodian, confirming the appropriate designation.

Payment firms should have an acknowledgement letter from the bank or custodian stating that the bank/custodian does not have an interest in, recourse against, or right over the relevant funds or assets in the safeguarded account. As part of this Consultation, the FCA has supplied a template letter for this purpose.

This letter also explicitly seeks to create a trust over the funds noting that the firm holds all the relevant funds or assets in the safeguarded account as trustee. As part of the Consultation, the FCA states its view that the safeguarding rules as found in the Regulations implicitly gives customers a beneficial interest in the funds in a safeguarding account.

Payment firms are required to ask their safeguarding institution or custodian to sign the letter as soon as practicable. Alternatively, firms should be able to demonstrate that the credit institution or custodian has no such interest in, recourse against, or right over the relevant funds or assets in that account.

c. Selecting, appointing and reviewing third parties

The FCA Consultation requires payment firms to undertake periodic reviews of their banks, custodians and insurers. These reviews should also be carried out

whenever a firm believes that anything affecting the appointment decision has materially changed, such as a credit downgrade, and in any event, at least once in each financial year.

d. When the safeguarding obligation starts

With respect to e-money institutions that allow customers to use their e-money to make payment transactions before the customer’s funds are credited to the firm’s payment account, the FCA Consultation clarifies that these firms do not need to treat these funds as safeguarded funds where they are available to meet the commitments it has to a card scheme or another third party to settle these payment transactions.

e. Unallocated funds

Where firms are unable to identify the customer to which funds it has received belong, it cannot issue e-money or provide a payment service. This could happen, for example, where the funds are received with an incorrect unique identifier such as an account name or number.

In this case, the FCA notes that these funds are not “relevant funds” under the Regulations but that firms are still required to protect these funds under Principle 10 of the FCA’s Principles for Business.

The FCA also clarified that for firms that issue e-money on low-value, pre-paid giftcards, where the identity of the ultimate card holder is not known, the funds received from customers are relevant funds, even though the identity of the e-money holder might not be known.

f. Annual Audit of Compliance with safeguarding requirements

The FCA now expects payments firms to arrange specific annual audits of their compliance with the safeguarding requirements under the Regulations. These audits should also occur whenever there are changes to the firm business model which would materially affect their safeguarding arrangements. For example, should an e-money issuer begin providing payment services unrelated to the issued e-money, an audit would need to be undertaken.

g. Small payment institutions

The FCA is not proposing to extend the safeguarding requirements in the Regulations to “small” payment institutions but does expect them to keep appropriate records. The FCA encourages these firms to opt into the safeguarding requirements in the Regulations.

h. Disclosing information on treatment of funds on insolvency to customers

The FCA stated its expectation that payment firms should avoid giving customers misleading impressions about how much protection they will get from the safeguarding requirements.

This is both in terms of the services to which the safeguarding requirements apply or by implying that the claims of customers would be paid in priority to the costs of distributing the safeguarded funds.

The FCA view is that this is necessary for firms to comply with the Consumer Protection for Unfair Trading Regulations 2008.

2. PRUDENT RISK MANAGEMENT

a. Governance and controls

Payment firms should ensure they have robust governance arrangements, effective procedures, and adequate internal control mechanisms, in accordance with their conditions of authorisation. A firm's senior management should ensure that the firm regularly reviews its systems and controls, including its governance arrangements.

b. Capital adequacy

The FCA Consultation provides that to reduce intra-group risk, the FCA considers it best practice for firms to deduct any assets representing intra-group receivables from their own funds. However, if there are legally enforceable netting arrangements in place, a firm could deduct only the net receivable amount (i.e. taking into account any intra-group amounts payable by the firm covered by those netting arrangements).

c. Liquidity and capital stress testing

The FCA expects payment firms to conduct liquidity and capital stress testing to analyse their exposure to severe business disruptions and assess their potential impact, using internal and/or external data and scenario analysis.

This mirrors the FCA's consultation on operational resilience which would also require payments firms to stress test the impact on operational resiliency of severe business disruptions. Payment firms should be aware, however, that the consultation on operational resilience has been delayed as a result of COVID-19. The FCA is only requiring liquidity and capital stress testing, and not stress testing operational resilience, at this

time. This approach is reasonable, given that firms are encountering real business impact at present as a result of COVID-19.

d. Risk-management arrangements

The FCA expects firms to consider their own liquid resources and available funding options to meet their liabilities as they fall due, and whether they need access to committed credit lines to manage their exposures.

To reduce exposure to intra-group risk, the FCA considers it best practice for firms not to include any uncommitted intra-group liquidity facilities when assessing whether they have adequate resources in place to cover the liquidity risk to which they are exposed.

e. Wind-down plans

The FCA Consultation provides that, in order to satisfy the FCA, payment firms must have a wind-down plan in place to manage their liquidity and resolution risks. The wind-down plan should consider the winding-down of the firm's business under different scenarios, including a solvent and insolvent scenario. The wind-down plan should address the following:

- funding to cover the solvent wind-down of the firm, including the return of all customer funds;
- realistic triggers to start a solvent wind-down;
- the need for any counterparties (i.e. merchants) to find alternative providers;
- realistic triggers to seek advice on entering an insolvency process; and
- information which would help an administrator or liquidator quickly identify customer funds and return them as a priority.

Next steps

The FCA plans to conduct a full consultation later in the year on changes to the FCA Approach Document. This further consultation will likely include a proposal to incorporate the guidance of this Consultation into the Approach Document.

The guidance as found in the present Consultation will remain in place until the Approach Document is updated following the full consultation later in 2020.

EU



ESMA – Response to the European Commission’s consultation on the digital finance strategy

On 29 June 2020, the European Securities and Markets Authority (ESMA) published its response to the European Commission’s consultation on a new digital finance strategy for the EU.

ESMA welcomed the European Commission’s consultation, noting that it built on the 2018 FinTech Action Plan, and provided responses to a number of questions which had been posed.

Risks and benefits of digitisation in the financial sector

ESMA drew attention to the increased speed, efficiency, convenience and economies of scale that firms could leverage from digitisation as well as the potential use of automated tools to detect cases of fraud or poor conduct.

Risks arising from digitisation include the increased likelihood and potential severity of data security or data privacy breaches as well as the possibility that firms could use new technology or data granularity to impose unfavourable pricing metrics on customers.

Promotion of a well-regulated data-driven financial sector

ESMA stressed that data harmonisation, IT security and legal certainty around responsibilities in the age of automation will be areas of focus to users seeking to use data more broadly.

In addition, ESMA noted that one area of particular interest is the potential for AI-based tools, such as machine learning, to support the ESMA’s statistics-related service.

How the EU policymakers can help remove fragmentation in the single market for digital financial services

ESMA reiterated the importance of addressing fragmentation in the single market for digital financial services through cooperation at the EU level.

In particular, ESMA drew attention to the ongoing work of the European Forum for Innovation Facilitators and specific initiatives around the use of e-signatures and legal entity identifiers.

The importance of ensuring a technologically-neutral EU financial services regulatory framework

ESMA emphasised that an EU-wide harmonised supervisory framework is necessary in order to allow innovative firms to scale up their businesses and to provide the necessary safeguards to investor protection, financial stability and orderly markets.

While ESMA was optimistic regarding the EU’s broad approach to digital finance by, for example, confirming that it agreed with the Commission’s choice of priority areas, it did highlight that the current regulatory framework was not designed with innovative technologies in mind.



ESMA identified the following challenges for both firms and supervisors going forward:

- A lack of clarity as to whether and exactly how the existing rules may apply to innovative business models and processes. Specifically, ESMA noted that different interpretations on the part of firms and across national supervisors may create inconsistencies and the potential for fragmentation between the EU member states.
- The fact that adaptations may be needed to allow for an effective application of existing rules, for example, when new technologies make certain operating processes redundant or uneconomical.
- The global nature of these new technologies mean that a coordinated response is required at both the EU and international levels. In particular, ESMA believes that the recent developments around so-called stablecoins require close scrutiny (including at international level) considering their potential to reach a large scale quickly and the risks that they may pose to financial stability.

ESMA also expressed concern in its responses that there may be a deficit of digital financial literacy on the part of certain consumers or investors, which could have a detrimental impact on investor protection and/or financial inclusion. ESMA gave an example of customers who are not comfortable using online services being excluded, where these “crowd out” other traditional modes of provision.

ESMA’s response to the consultation was accompanied by a letter from Steven Majoor, the ESMA Chair summarising its main comments. Mr Majoor noted, among other observations, that digital transformation of the financial sector continues to have profound consequences for ESMA’s objectives of protecting investors and ensuring stable and orderly financial markets and that the Commission’s strategic work in the area is therefore “highly relevant” to ESMA’s own work.

European Commission issues notice to stakeholders post-Brexit

On 13 July 2020, the European Commission (EC) published a notice to stakeholders post-Brexit. As the UK has withdrawn from the EU, the Withdrawal Agreement provides for a transition period ending on 31 December 2020.

This notice reminds various parties, economic and financial operators, of the implications that the end of the transition period will have on their activities. Following the transition period, the EU rules of the MiFID framework for investment services and activities no longer apply to the UK.

Below are some of the consequences the EC have highlighted:

Authorisations

- **EU passport:** following the transition period, entities established and authorised by UK competent authorities will no longer benefit from the MiFID authorisation and will lose their "EU passport."
- **EU subsidiaries:** legally independent companies established in the EU and controlled by or affiliated to firms established or authorised in the UK can continue to operate as EU investment firms if they have obtained a MiFID authorisation in one of the EU Member States.
- **Branches in the EU of UK investment firms:** these branches will become branches of third-country investment firms, required to comply with national requirements applicable in the Member State where the branch is established.
- **Section C(6) of Annex I of MiFID II:** in order not to be considered as a financial instrument, a derivative contract must meet three conditions:
 - it must qualify as a wholesale energy product;
 - it must be traded on an Organised Trading Facility (OTF); and
 - it must be physically settled. The end of the transition period will have an impact on the first two conditions.

- **UK-based trading venues and central counterparties (CCPs):** UK trading venues and CCPs will no longer benefit from the open and non-discriminatory access to EU trading venues and EU CCPs, as well as EU benchmarks.

Contracts

- **Relationships with EU clients/counterparts:** the ability of UK established firms to continue performing certain obligations and activities deriving from existing contracts may be affected post-Brexit. The EC suggests that firms carefully assess the impact of the end of the transition period on their operations and identify and mitigate risks.

Other aspects

- **Outsourcing:** the outsourcing of certain operational functions to UK providers may be undertaken only when in compliance with relevant MiFID requirements. The European Securities and Markets Authority (ESMA) has issued opinions with specific clarifications on these matters, in particular on the risks of letter-box entities which may arise from the use of outsourcing arrangements.
- **Disclosure:** firms providing investment services are required to provide clients or potential clients with accurate disclosure, in good time and in any case before clients are bound by any contract, on the impact on the provision of services and investors' rights that may emerge from the end of the transition period.
- **Article 59 MiFID II:** UK-based data reporting service providers which have not obtained a MiFID authorisation by a competent authority established in the EU will have to cease to serve EU markets.

ESMA publishes 2019 annual report and updates 2020 annual work programme

On 15 June 2020, the European Securities and Markets Authority (ESMA) published its 2019 Annual Report, which included a revised version of its 2020 Annual Work Programme and a review of its key actions from 2019.

Revised 2020 annual work programme

ESMA highlighted the additional work it had undertaken in response to the COVID-19 crisis and indicated that this may lead to a potential reprioritisation of its ongoing and future mandates. As part of the activities undertaken through the work programme, ESMA has re-iterated its intention to:

- drive initiatives for financial innovation, concentrating on the regulation and supervision of initial coin offerings and crypto assets, innovative fintech business models, national innovation hubs and regulatory sandboxes as well as cybersecurity;
- work with national competent authorities to ensure a coordinated European response to the COVID-19 crisis. As part of this effort, ESMA will continue to conduct necessary supervisory convergence work including the continued use of peer reviews and Q&As;
- cooperate with the European Banking Authority (EBA) on the development of technical standards and other legal acts required under the new prudential framework for investment firms. This will include the drafting of regulatory and implementing technical standards as well as required work on the changes to the third-country regime for the provision of investment services by third-country firms;

- improve the disclosure of information by manufacturers of sustainable financial products and financial advisors. ESMA will develop, jointly with EBA and European Insurance and Occupational Pensions Authority (EIOPA), the implementing and regulatory technical standards on the disclosure provisions for sustainable investments, with these standards expected to be delivered in January 2021; and
- monitor the implementation of the requirements related to the European Single Electronic Format (ESEF) and consider if there is a need to provide further assistance to market participants to ensure the highest possible convergence across all EU jurisdictions.

These initiatives align with ESMA's key priorities for 2020, which include the implementation of its new supervisory mandates, the strengthening of supervisory convergence, the development of the single rulebook, the promotion of cooperation and improved statistics in relation to risk assessments and its ongoing direct supervision of credit rating agencies, trade repositories and entities under the Securitisation Regulation.

As part of its reprioritisation exercise, ESMA also noted that it would extend the consultation period for some consultations, to allow market participants to be able to provide responses during the pandemic.

ESMA guidelines on compliance function under MiFID II

On 5 June 2020, the European Securities and Markets Authority (ESMA) published new guidelines for the Compliance Function under the second Markets in Financial Instruments Directive 2014/65/EU (MiFID II), replacing the previous ESMA guidelines on the same topic issued in 2012.

These guidelines are aimed at senior managers who, as part of their obligations under MiFID II, must ensure that the compliance function fulfils the requirements set out in Article 22 of MiFID II.

The 2020 guidelines

While the objectives of the compliance function as well as the key principles underpinning the regulatory requirements have remained unchanged, the obligations have been further detailed under MiFID II. The substantive changes to the Guidelines are set out below:

- **Guideline 1** (compliance risk assessments) includes an enhanced requirement for the compliance function to conduct a formal risk assessment, including a requirement to assess financial instruments traded and distributed, the categories of a firm's clients, the distribution channels of the firm and, where relevant the internal organisation of the group.
- **Guideline 2** (compliance monitoring) requires the compliance function to review a relevant sample of the firm's clients and interview a sample of the firm's clients.
- **Guideline 3** (reporting) has an additional focus on a firm's management needing to review "mandatory compliance reports" in respect of all investment services, activities and ancillary services provided by a firm.
- **Guideline 4** (advisory and assistance obligations) provides emphasis on compliance providing training for management functions and senior management setting the compliance culture that not only focuses on investor protection, but also on "the stability of the financial system."
- **Guideline 5** (organisational requirements) focuses more on effective communication between the compliance function and other control functions such as internal audit and risk management as well as with any internal or external auditors.
- **Guideline 6** is a new Guideline entirely, that centralises and expands the requirements on the skills, knowledge, and expertise of the compliance function but also emphasises that all compliance staff should have necessary skills, knowledge, expertise and authority to discharge their obligations.
- **Guidelines 7, 8, 9, 10** (permanence of the compliance function), (independence of the compliance function), (proportionality and effectiveness of compliance function) and (on combination of compliance with other internal control functions) have been amended only in terms of language.
- **Guideline 11** (outsourcing) highlights that outsourcing can only involve a delegation of tasks and not responsibilities, other changes are reflective of the principles of insourcing functions back to the firm or transferring to another outsourcing provider in the event of termination of an outsourcing arrangement. Most importantly in para. 80 the 2020 Guidelines introduce a new obligation on firms that: "Outsourcing of all or part of the tasks of the compliance function to non-EU entities may potentially make oversight and supervision of the compliance function more difficult and should therefore be subject to a closer monitoring."
- **Guideline 12** (standards on the review of the compliance function by competent authorities) reiterates principles first established in the original MiFID and also points (in para. 87 of the 2020 Guidelines) to practices employed in some Member States such as a compliance officer preparing and filing an annual questionnaire permitting the competent authority to gather information on compliance of the firm.

Next steps

The 2020 guidelines will be translated and the publication of the translations in all official languages of the EU will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines.



EBA thematic report on the impact of COVID-19 on the EU banking sector

On 25 May 2020, the European Banking Authority (EBA) published a Thematic Note setting out its preliminary analysis on the impact of the COVID-19 pandemic on the EU banking sector (Thematic Note). The EBA's assessment is mainly based on supervisory reporting data (particularly Q4 2019 data) submitted by a sample of EU banks, excluding UK banks.

The overall analysis suggests that the EU banking sector is generally resilient and able to withstand the shock, despite the unprecedented challenges the global economy is facing due to the COVID-19 crisis.

State of the EU banking industry

According to the Thematic Note, EU banks are better prepared, in terms of both capital and liquidity levels, compared to previous crises. Banks now hold larger capital and liquidity buffers, compared, for example, to the global financial crisis in 2008-2009.

For instance, the Common Equity Tier 1 (CET1) ratio for EU banks has increased from 9% in 2009 to approximately 15% in Q4 2019, which is well above the regulatory requirements. In a similar vein, banks' overall Liquidity Coverage Ratio (LCR) was around 150% in Q1 2020, which is also above the regulatory minimum.

The Thematic Note does say however that a number of vulnerabilities persist. Since the end of 2019, the profitability levels of banks have remained low and many banks struggle to earn their cost of equity. In addition, the low interest rate environment, which already existed before the crisis, is expected to continue for an even longer period of time.

Impact of COVID-19

The Thematic Note highlights that a key concern is that the COVID-19 pandemic is expected to have an adverse impact on asset quality. In the last few years, EU banks have generally increased their exposures towards more risky borrowers, such as small and medium-sized enterprises (SMEs) or consumers. The Thematic Note states that it is anticipated that banks will face growing Non-Performing Loan (NPL) volumes, as a result of the COVID-19 pandemic, which could potentially reach levels similar to those recorded following the sovereign debt crisis. The fall in asset quality could be accompanied by increased Risk-Weighted Assets (RWAs).

On the basis of a sensitivity analysis performed, taking into account the 2018 EBA stress test results, it is estimated that credit risk losses could reach up to 3.8% of RWAs. This means that the EU banking sector would on average have enough capital to address potential losses under the most severe credit risk shock.

Measures taken to mitigate the economic effects of the COVID-19 crisis, such as the provision of state-guarantees, could potentially soften the negative impact of the pandemic. In addition, the EBA guidelines on loan moratoria will prevent the automatic classification of affected exposures having increased credit risk or having defaulted. It is expected, however, that the impact of the pandemic will differ among banks. For example, banks with idiosyncratic weaknesses or with large exposures to most affected sectors will be most affected by the COVID-19 crisis.

The Thematic Note also points out that funding conditions have deteriorated significantly due to the COVID-19 crisis. Spreads have widened significantly since February 2020 and new unsecured debt issuances came to a halt in the period to mid-April. In addition, approximately 20% of securities issued by banks will mature in the following six months, while an additional 10% will mature within one year. As a result, banks have been relying increasingly on central bank funding. They have also been using their liquidity buffers and are expected to continue to do so in the next months.

Lastly, according to the Thematic Note, EU banks are facing pressure in terms of operational resilience. Since the wake of the pandemic, banks have been implementing their contingency plans in order to be able to keep their core functions unaffected, to the extent possible. This has included, for example, setting up ad hoc crisis and remote units and the extension of teleworking. However, the need to handle large volumes of applications for debt moratoria and guaranteed loans has put additional pressure on banks. Moreover, it was observed that some banks' offshore units were not sufficiently prepared to work remotely.



Spain



Third-country banks authorised to operate cross-border in Spain will not be able to carry out deposit taking activities

The Spanish draft bill implementing Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 (CRD V), published for public consultation by the Spanish Ministry of Economy in the beginning of August, includes a very relevant change in the regime for authorisation of third country banks.

In particular, the draft bill provides that any third-country bank authorised by the Spanish authority (the Bank of Spain) for the provision of cross-border services in Spain will not be able to carry out deposit-taking activities with Spanish resident clients.

This means that any third-country banks wishing to take deposits from Spanish clients will need to request the authorisation to establish a branch in Spain, as the cross-border authorisation will not allow the deposit-taking activity.

The draft bill is expected to enter into force by 28 December 2020, in line with the implementation deadline of CRD V.



Bank of Spain approves new rules on advertising of banking products and services

On 15 July 2020, Circular 4/2020 of 26 June of the Bank of Spain, on advertising of banking products and services (the Circular) was published in the Spanish Official Gazette.

The Circular aims to adapt to the evolution of the advertising sector and the impact of digital technology, and further develops the changes introduced by the Order ACE/482/2019, of 26 April, that amends the Order EHA/1718/2010, of 11 June, regarding regulation and control of advertising of banking services and products (please also see our previous FinBrief post about the publication of the Order ECE/482/2019 here).

This Circular will come into force on 15 October 2020, except for the requirement relating to internal advertising records, described below, which will come into force six months after the publication by the Bank of Spain of the technical specifications that the records must meet.

The Circular is applicable not only to financial institutions with an establishment in Spain, but also to entities operating in Spain under the freedom to provide services without a branch. However, entities providing services on a cross-border basis will not be required to have the commercial communication policy and the internal records mentioned below.

The Circular develops Order EHA/1718/2010 and further specifies what is meant by advertising activity. Specifically, it is defined as any form of advertising support, regardless of the media, and advertising formats used for their dissemination. For the first time, the Circular introduces a specific regime for advertising in audiovisual, radio or digital media and social networks.

The procedures and internal controls required for entities to carry out advertising activities are detailed. In this regard, entities must have a commercial communication policy that must be approved by the relevant management body. Likewise, entities must keep internal records, duly updated and at the disposal of the Bank of Spain, of all advertising campaigns identified by correlative order number and commercial name and with the minimum documentation contained in the Circular.

Entities, when advertising banking products and services in Spanish territory for the first time, will communicate this to the Bank of Spain within one month from the day following the start of the advertising activity. This requirement, unlike the rest of the Circular, will apply from 16 July 2020.



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France



French and US authorities sign MOU to accelerate international cooperation on fintech

The French Autorité de contrôle prudentiel et de résolution (ACPR) announced on Wednesday, 3 June that it has entered into a fintech coordination agreement with the New York State Department of Financial Services (NYDFS) to promote regulatory compliance and ensure that fintech innovators have a smooth entry into both markets.

The agreement was signed by Mr. François Villeroy de Galhau, Governor of the Banque de France and President of ACPR, and Mrs. Linda A. Lacewell, Superintendent of the NYDFS.

The cooperation agreement seeks in particular to:

- facilitate increased cross-border activity and investment opportunities in both French and US markets;
- increase support by the authorities of both countries to fintech companies in France and New York state to help them better understand the regulations in each of these jurisdictions; and

- implement a framework seeking to facilitate the entry of fintech companies in each other's jurisdictions, and includes specific actions that each regulator can undertake, including referrals, information and expertise-sharing, providing support to FinTech companies.

This agreement marks the first fintech cooperation agreement between ACPR and a US regulator and is in line with ACPR's active policy of international cooperation in the field of fintech. It supplements the fintech cooperation agreements signed with other non-European authorities in Singapore, Hong Kong, Korea, Japan and Taiwan.

US



National banks may provide cryptocurrency custody services – exchanges will soon face competition

On 22 July 2020, the Office of the Comptroller of the Currency (OCC) issued Interpretive Letter #1170 concluding that national banks and federal savings associations have the authority to provide cryptocurrency custody services for their customers, including holding the unique cryptographic keys associated with the cryptocurrency. The bank or savings association must still implement appropriate controls and systems to mitigate risk, and otherwise comply with applicable law.

The OCC concluded that providing cryptocurrency custody services “is a modern form of ... traditional bank activities,” specifically “an electronic corollary of ... traditional safekeeping activities.” The OCC’s interpretation came as a logical extension of the OCC’s prior approval of bank services concerning electronic safekeeping activities. These activities include escrowing encryption keys used in connection with digital certificates, and providing secure web-based document storage, retrieval and collaboration of documents and files including acting as a custodian for transferable records and electronic chattel paper, as codified in 12 CFR Part 7.

Analogising cryptocurrency custody services to traditional asset custody services, the OCC explained that such services may range from simple holding of

copies of the cryptographic keys enabling transfer of the customer’s cryptocurrency to related services such as those currently provided by cryptocurrency exchanges – facilitating the customer’s cryptocurrency and fiat currency exchange transactions, transaction settlement, trade execution, recording keeping, valuation, tax services, reporting or other appropriate services.

The OCC further noted that bank cryptocurrency custody services may be offered, like traditional custody services, in either a fiduciary or non-fiduciary capacity. Additionally, the OCC stated that banks, as regulated entities, may offer more secure storage services compared to cryptocurrency exchanges and other available options. Each of these services offerings may make banks more attractive to institutional investors in cryptocurrency.

Cryptocurrencies – also known as digital currencies or virtual currencies – are designed to work as a medium of exchange and are created and stored electronically. Depending on the type of cryptocurrency, it may have characteristics of either fiat money or money backed by some underlying asset(s) or claim(s). Furthermore, the OCC also contemplates that cryptocurrency may include digital assets “not broadly used as currencies” but did not elaborate further.

In the letter, the OCC reminded banks that they must address the risks associated with the account and customer, including compliance with anti-money laundering rules. Moreover, the unique aspects of cryptocurrency may require the development and implementation of additional controls and processes not utilised with traditional custody services, such as specialised audit procedures to ensure the bank's controls are effective for digital custody activities. Additionally, banks must address considerations for different types of cryptocurrency which are subject to other regulations, such as those of the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC), with respect to those cryptocurrencies considered to be securities or commodities, respectively. These additional regulations may require other procedures, processes or reporting.

The OCC notably did not discuss the details of an approval process for banks seeking to undertake cryptocurrency custody services. Communication with OCC examination staff is likely advisable, and the profile of each bank will determine the level of OCC review and support needed. The OCC expects bank management and the board to have experience and knowledge to support the activity, which is the case for OCC-chartered banks offering other new products as well. Further, formal approval of business plan revisions may be triggered if new cryptocurrency custody activity represents a material deviation for banks operating under a formal business plan.

To assist and direct banks seeking to adopt cryptocurrency custody services, the OCC advises that “[b]anks seeking to engage in these activities should also conduct legal analysis to ensure that the activities are conducted consistent with all applicable laws.”





Fed unveils real-time payment system

The Federal Reserve (the Fed) on 6 August 2020 announced the details of the FedNowSM Service, a new-round-the clock interbank settlement service with clearing functionality to support instant payments in the US. The Fed said its goal is to develop a widely accessible, 24/7/365 instant payments infrastructure that would “modernise the US payment system and bring the benefits of instant payments broadly to communities across the country.”

In its Federal Register notice of 11 August, the Fed said it will take a phased approach to implementation. The first release of the FedNow Service will provide core clearing and settlement features that will support market needs and help banks manage the transition to a 24/7/365 service. Additional features and service enhancements will be introduced over time, with the input of stakeholders. The target launch date for the service is 2023 or 2024, with a more specific timeframe to be announced after additional work is completed. FedNow would exist alongside the system launched by the Clearing House Payments Co., a private-sector payment system infrastructure that operates the Small Value Payments Company (SVPCO), an electronic check clearing and settlement system, and the Clearing House Interbank Payments System (CHIPS), an automated funds transfer system for domestic and international high-value payment transactions in USD.

“The rapid expenditure of... emergency relief payments highlighted the critical importance of having a resilient instant payments infrastructure with nationwide reach, especially for households and small businesses with cash flow constraints,” said Federal Reserve Board Governor Lael Brainard. The Fed had announced its intention to create the instant payments service almost a year earlier to the day of the latest announcement and has since been receiving public comments on how the platform should function.



Agencies finalise Volcker Rule modifications

Five financial regulatory agencies have approved final amendments to the covered funds portion of the regulations implementing the Volcker Rule. The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) announced the publication of the final rule on 26 June 2020. The final rule modifies the Volcker Rule's prohibition on banking entities investing in or sponsoring hedge funds or private equity funds, known as covered funds. The final rule is broadly similar to the agencies' proposed rule from January, with a few key exceptions:

- A new exclusion for family wealth management vehicles that are not organised as trusts to be owned by up to five closely related persons of the family customers (rather than three, as originally proposed).
- A US banking entity and its associated parties may own up to 24.9% of the ownership interests in a foreign public fund that is sponsored by the US banking entity, instead of up to 14.9%.
- A loan securitisation vehicle may hold certain debt securities that represent up to 5% of the aggregate value of the securitisation vehicle's assets.
- A qualifying foreign excluded fund (QFEF) is not subject to the Volcker Rule compliance program requirements that are otherwise applicable to banking entities.
- Banks may enter into lower risk principal transactions with a related covered fund, regardless of whether that covered fund is a "securities affiliate" as defined in Regulation W.

- The types of events that qualify as "cause" for removal of an investment manager for purposes of the ownership interest definition are clarified.

The agencies made no substantive amendments to the proprietary trading provisions or the compliance program requirements of the Volcker Rule other than to provide exemptions for QFEFs. The agencies also confirmed in the preamble that the final amendments do not modify or revoke any of the Volcker Rule FAQs previously issued by staff of the agencies, unless otherwise specified. The Volcker Rule generally prohibits banks from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund. Like the proposal, the final rule modifies three areas of the rule by:

- streamlining the covered funds portion of rule;
- addressing the extraterritorial treatment of certain foreign funds; and
- permitting banks to offer financial services and engage in other activities that do not raise concerns that the Volcker Rule was intended to address.

The rule will be effective on 1 October.



Mexico



Mexican banking authorities issue new fintech regulations

Mexico's National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, or CNBV) recently issued new regulations pursuant to the Law to Regulate Financial Technology Institutions (*Ley para regular las Instituciones de Tecnología Financiera*), commonly known as the fintech law. These new regulations – published on 4 June 2020 in the Mexican Official Gazette (*Diario Oficial de la Federación*) – provide guidelines on the establishment of application programming interfaces (APIs) to enable connectivity, access and sharing of certain data between FTIs, or fintechs. These interface guidelines also establish security standards to protect the infrastructure and confidentiality of the data exchanged, architectural framework, and a dictionary for ATMs for the exchange of information and a procedure to follow in case of a data breach. The types of data to be shared under the Law are:

- **Open data:** Information generated by the Regulated Entities that does not contain confidential information – for example, general information on the products or services offered and the location of their offices, branches, ATMs and other points of access to their products and services.
- **Aggregated:** Statistical information on transactions conducted by or through Regulated Entities which is presented in a way that prevents personally identifiable information (PII) or individual transaction records to be exchanged.

- **Transactional:** Data related to the use by clients of the Regulated Entities of a specific product or service, including deposit accounts, loans and other means of withdrawal, which data constitute PII and therefore may only be shared with clients' prior consent (which shall specify the purpose of sharing).

The fintech law, adopted in 2018, regulates two types of institutions:

- **Collective Financing Institutions** (*Instituciones de Financiamiento Colectivo*): Crowdfunding institutions that connect applicants and investors, through computer applications, interfaces, internet pages or any other means of electronic or digital communication, to provide funds to applicants' businesses (including debt, equity and rewards-based crowdfunding).
- **Electronic payment funds institutions** (*Instituciones de Fondos de Pago Electrónico*), or electronic wallets: Institutions whose purpose is the issuance, administration, redemption and transmission of electronic payment funds, including national currency, foreign currency or virtual assets (cryptocurrencies), through means of electronic or digital communication.



International

Basel Committee consults on principles for operational risk and operational resilience

On 6 August 2020, the Basel Committee on Banking Supervision (BCBS) published two consultation papers on proposed Principles for operational resilience (Draft Principles) and proposed updates to its Principles for the sound management of operational risk (PSMOR).

The Draft Principles on operational resilience aim to mitigate the impact of potentially severe adverse events (e.g. risks arising from pandemics, cyber incidents, technology failure or natural disasters) by strengthening institutions' ability to withstand, adapt to and recover from them. According to the BCBS, operational resilience requires effective operational risk management. Risk identification and assessment, risk mitigation (including the implementation of controls) and ongoing monitoring work can play an important role in minimising operational disruptions and their effects when these materialise.

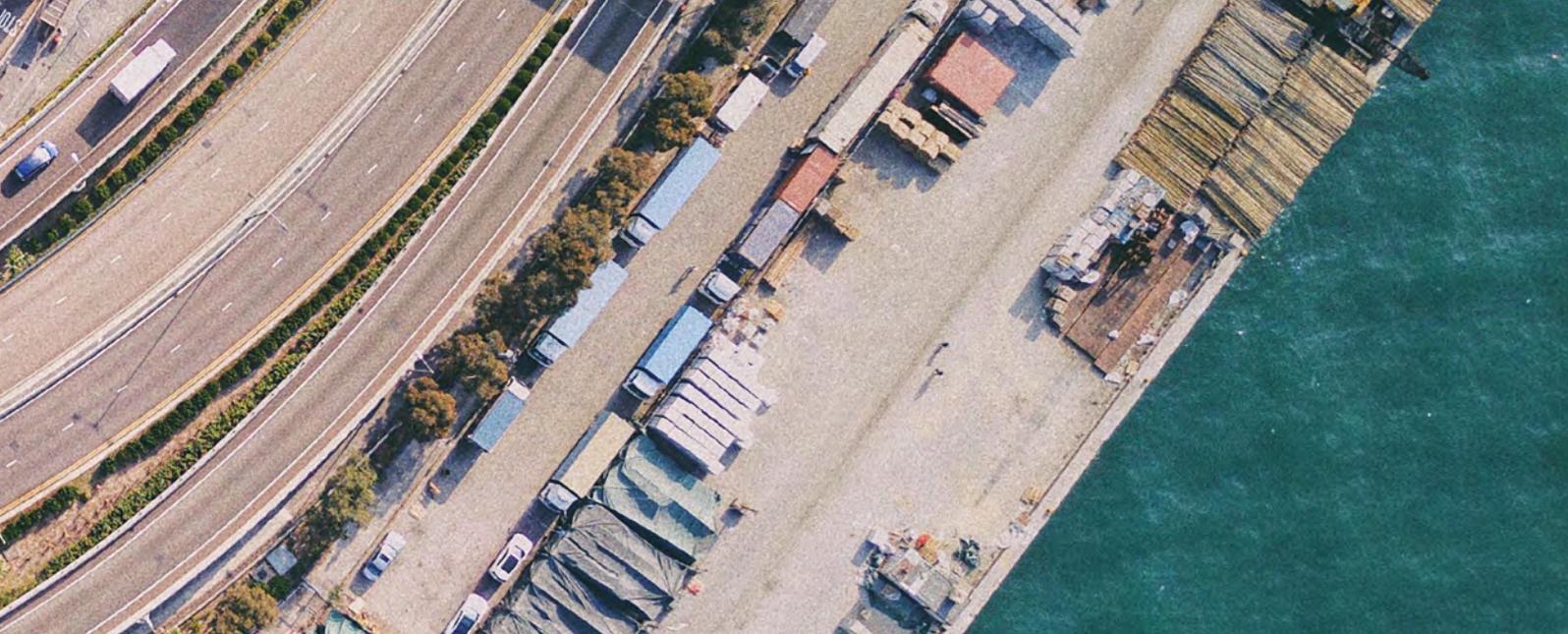
The Draft Principles build upon existing guidance on outsourcing, business continuity and risk management-related guidance previously issued

by the BCBS or national supervisors. The principles focus on governance; operational risk management; business continuity planning and testing; mapping interconnections and interdependencies; third-party dependency management; incident management; and resilient cybersecurity and Information Communication Technology (ICT).

The BCBS is also proposing updates to its PSMOR, aiming to:

- align the PSMOR with the finalised operational risk framework under Basel III;
- update its guidance where necessary in the areas of change management and ICT; and
- provide more clarity on the relevant principles.

Stakeholders must provide comments by Friday 6 November 2020.



IOSCO final guidance on measures to reduce conflict of interests in debt capital raising

On 21 September 2020, the Board of the International Organisation of Securities Commissions (IOSCO) published its final report on conflicts of interest and associated conduct risks during the debt capital raising process (Report). The Report aims to address – among other things – specific concerns raised by certain regulators during the COVID-19 pandemic that may affect the integrity of the capital raising process.

The Report also discusses the potential benefits and risks of blockchain technology in mitigating conflicts of interest in the debt capital raising process.

The Report outlines the main stages of the debt raising process and identifies where the involvement of intermediaries might give rise to conflicts of interest. It also sets out nine measures that regulators should consider in order to address potential issues that may arise. These require regulators to consider the following:

1. Firms are required to manage conflicts of interest that may arise as part of the pricing process of a debt securities offering and to keep the issuer informed about matters concerning such pricing process.
2. Firms are required to take reasonable steps to disclose to the issuer how any risk management transactions it intends to put in place for itself, the issuer, or investor clients, will not undermine the issuer's interests in connection with pricing of the new issuance.
3. Firms are encouraged to provide timely information to investors, where this is not prohibited under local law.
4. Firms are required to maintain appropriate controls to identify, prevent where possible and manage any conflicts of interest that arise in the preparation of research relating to the offering.
5. Firms are required to have an allocation policy that outlines their approach for determining allocations in a debt securities offering, and to assess their compliance with such policy regularly.
6. Firms are encouraged to consider their issuer client's preferences, such as investor profile and composition, when making allocation decisions or recommendations.
7. Firms are required to have appropriate controls to identify, avoid where possible and manage any conflicts of interest that arise in connection with the allocation recommendations of the offering.
8. Firms are required to maintain records of allocation decisions to be able to demonstrate that any conflicts of interest are appropriately managed.
9. Firms are required to observe proper standards of market conduct, act with integrity, manage conflicts of interest, and to treat clients fairly when negotiating to secure a mandate for a debt offering.

The Report focuses on traditional corporate bonds, but the relevant measures may be also applied to capital raisings through other types of debt securities.



In Focus

E-signatures in the UK during the COVID-19 pandemic

The disruption as a result of the COVID-19 pandemic has brought into focus the importance of firms ensuring operational resilience and continuation of service at a time of social distancing and mass lockdown. In this respect, one issue which comes up repeatedly in our conversations with clients is how legal agreements can be validly executed in an era of remote working.

This is where it is extremely useful for clients to understand the legal framework governing the use of electronic signatures (e-signatures) under English law.

What are e-signatures?

An e-signature is widely defined in both European[1] and English law[2] to capture anything in electronic form which is attached to or logically associated with other electronic data and which is used by the signatory to sign. This might include, for example, a scanned manuscript signature, clicking an “I accept” box on a website or the use of an e-signature platform to insert writing into the execution block.

Permissibility of e-signatures under English law

Unlike European law, which follows a tiered approach in designating three levels of e-signatures under the eIDAS Regulation, English law has taken a historically permissive approach to the use of e-signatures and does not traditionally distinguish between various types.

This means that, assuming all other contractual formalities are satisfied, an e-signature will be a valid method for executing documents under English law.

In addition, the Law Commission has also confirmed in recent years that e-signatures are both admissible in legal proceedings and can constitute a valid method for executing deeds.

Exceptions where a physical signature is recommended

That said, there are certain documents where it remains prudent to persist with the use of “wet-ink” signatures. In particular, the Land Registry and HMRC have thus far been reticent to accept electronically executed



documents. Therefore, real property and tax-related documents which require filing at these registries (e.g. legal mortgages or documents where stamp duty is payable) should generally be executed by wet-ink signature. In addition, where evidencing the location of signing is important (e.g. due to tax considerations or when witnessing deeds) parties may feel a physical signature is more appropriate.

That said, aside from these relatively limited exceptions, e-signatures are generally seen as a valid means of execution for the vast majority of documents under English law.

Recent developments

Indeed, in recent weeks, the use of e-signatures in financial markets has received tacit recognition from one of the UK's primary financial services regulators, the Financial Conduct Authority (FCA). On 20 April 2020, the FCA released a statement noting that they do not explicitly require wet-ink signatures in agreements and that e-signatures will generally be acceptable for any interactions firms have with the regulator. While the FCA acknowledged that firms would need to consider their own legal advice and apply the FCA's usual principles of business with regards to the execution of client documents more generally, this is generally seen as a positive endorsement of e-signing practices from the regulator.

In addition, policymakers have also provided helpful clarification around the use of e-signatures for executing wills. Here there is an acknowledgment of the difficulty of obtaining valid execution while complying with government guidance on social distancing and, as a result, the Law Society has confirmed that, while it is not possible to witness a will via video-conferencing under the current law, it is possible to supervise the signing of a will using electronic means where you are not acting as a witness to the will. This clarification is designed to make the execution of such documents more feasible in the current environment.

Conclusion

Aside from the limited exemptions outlined above, e-signatures represent a practical, cost effective and legally valid method for companies to execute documents, particularly with so many employees working remotely during the COVID-19 pandemic.

As a firm, we are encouraging all our clients to consider the use of e-signatures where possible in order to facilitate compliance with the government's social distancing guidelines.

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