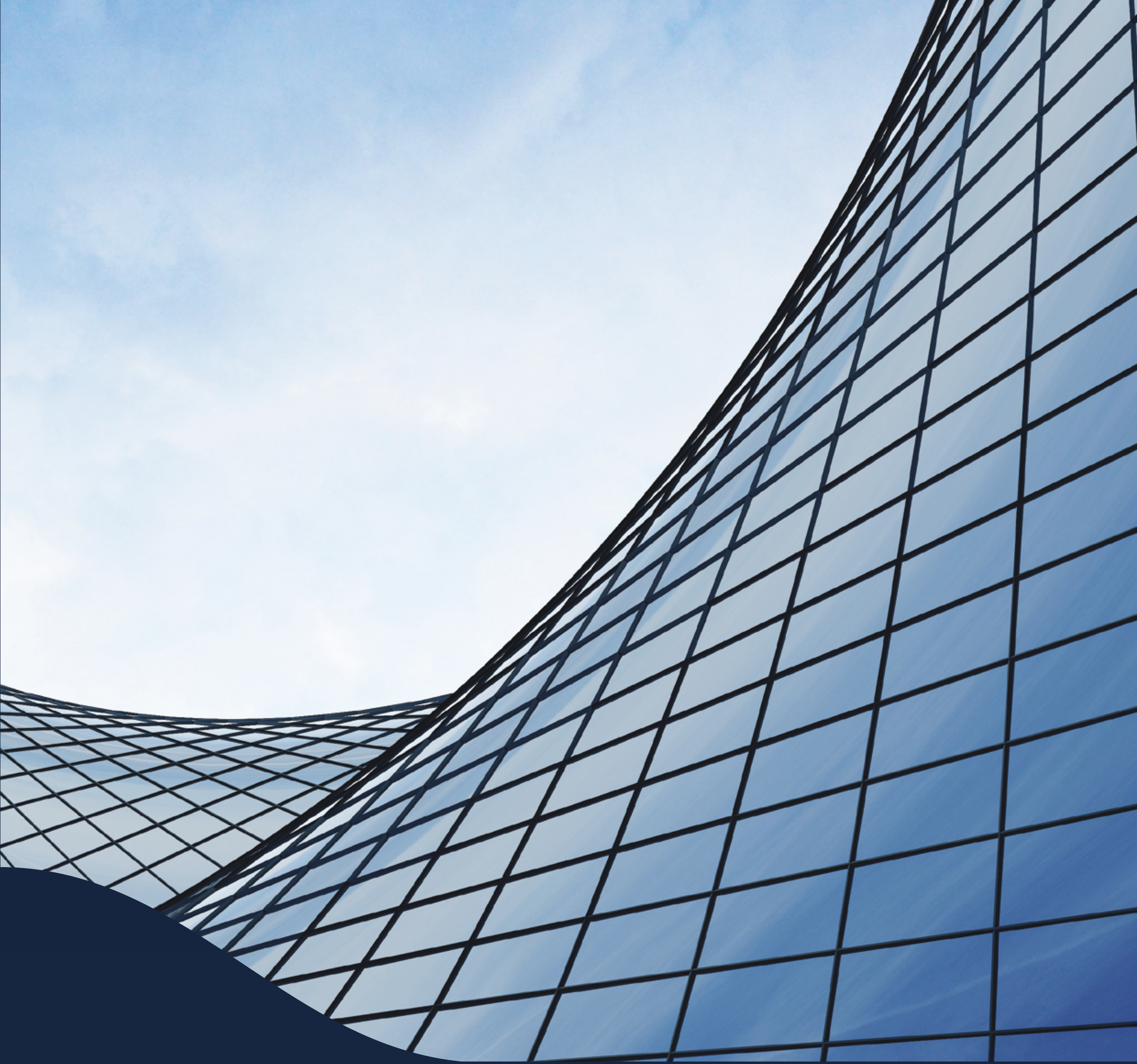

# Exchange – International

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DLA PIPER

# Introduction

## Welcome

DLA Piper's Financial Services International Regulatory team welcomes you to the 49th 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 UK, the EU, Spain, Belgium, the Netherlands, Canada and the US in addition to commentary on general international developments.

In Focus looks at the UK's Financial Services and Markets Bill 2022 and asks whether it has the potential to lead to a second 'big bang' in financial services regulation.

In the UK, we look at the Financial Conduct Authority's (FCA) final rules and guidance published on its new Consumer Duty (PS22/9 and FG22/5) as well as His Majesty's Revenue and Customs (HMRC) approach to stablecoins and crypto regulation. In addition, we are looking at the 70th edition of the Financial Conduct Authority's (FCA) market watch newsletter, and the FCAs sustainability disclosure requirements as well as artificial intelligence regulation.

Looking at international developments, the European Union has reached a provisional agreement on its crypto asset regulation (MiCA) and in the Netherlands the recent publication of the administrative fine Dutch Central Bank imposed on Binance Holdings Limited for violating the registration requirement for crypto service providers.

In Canada and Spain we comment on the discontinuation of publishing the Canadian Dollar Offered Rate (CDOR) and asset management related updates respectively. We also draw attention to recent developments in the Unites States, including the Federal Reserve Board's new rules on instant payments, the Federal Deposit Insurance Corporation (FDIC) draft on climate risk management principles and the New York DFS issues guidance for stablecoins.

On a wider international level, we comment on a paper by the Financial Stability Institute (FSI) on big tech regulation, in addition to a separate piece on crypo asset litigation.

We sincerely hope that you find the contents of this edition of value and interest. If you have any comments or suggestions for future issues, we welcome your feedback.

The DLA Piper Financial Services Regulatory Team

December 2022

# Contents

# UK

# The FCA Consumer Duty: A strategic policy to shift industry behaviour

The FCA has now published its final rules and guidance on its new Consumer Duty (PS22/9 and FG22/5) which are designed to fundamentally shift the mindset of firms in how they deliver for consumers. The implementation of the Consumer Duty is a flagship initiative for the FCA, setting out its expectations of the industry over the next years. The FCA is requiring the industry to put the customer at the heart of what they do and to be able to demonstrate how they are achieving good outcomes for customers. The governance and operational changes expected under the rules should not be underestimated by firms.

Given the far-reaching impact, it is pleasing to see that the FCA listened to the industry and implemented a phased implementation. The Consumer Duty will apply to all new products and services from 31 July 2023, and closed products and services from 31 July 2024.

The FCA's approach is not particularly novel. They have done this before for many other implementations. For example:

Boards (or equivalent management body) should agree implementation plans by end of October 2022 and maintain oversight of their delivery. Firms should expect the FCA to ask for implementation plans, board papers and minutes etc. and be challenged on their contents. The FCA is also expecting Boards to appoint consumer duty champions so that the new duty permeates.

Manufacturers should aim to complete all reviews necessary for existing open products by the end of April 2023 so they can share necessary information with distributors for them to meet their obligations; and identify where changes need to be made to their existing open products and services to meet the Duty and implement these remedies by the end of July 2023.

Firms should consider taking actions that can be completed quickly before the end of the implementation period.

Remediation of serious issues identified by the firm should be prioritised.

Whilst this is helpful guidance for firms, there will inevitably be pressures on firms to meet these milestones, especially as the FCA will be seeking explanations where progress is too slow.

The FCA does leave open the possibility that firms can take a risk-based approach to implementation where they may be struggling to ensure full compliance. The FCA has said that firms should take a risk-based approach and prioritise implementation work that is likely to have the biggest impact on consumer outcomes, eg by reviewing the most complex or risky products and the most significant communications.

As expected, implementation of the Consumer Duty will be at the heart of the FCA's ongoing authorisation, supervision and enforcement programme. Firms should expect the FCA to be monitoring their implementation progress and be involved where firms are failing to make sufficient progress, and as the firm starts implementing changes to its business such as withdrawing or restricting access to products or services or making changes to existing products.

Look out for future updates from DLA Piper on the implications of the new Consumer Duty.

# UK Regulatory Approach to Stablecoins: HM Treasury Consultation Response

Since its launch, the cryptoasset market has developed at a rapid pace, with total market capitalisation for cryptoassets estimated to be USD2.6 – 3 trillion in 2021. The market for decentralised finance (DeFi), although small in current scope is expanding quickly too from less than USD10 billion in 2020 to nearly USD100 billion in 2021. In consumer research conducted by the Financial Conduct Authority (FCA), the uptake of cryptoassets among UK consumers has further increased with GDP2.3 million (from GDP1.9 million last year) adults estimated to hold cryptoassets. The government has been keen to note the growing interconnectedness between cryptoassets and the wider financial system.

In January 2021, HM Treasury launched a Consultation and Call for Evidence on the regulatory approach to cryptoassets and stablecoins. The intention of the consultation was to source views on how the UK can structure the regulatory framework to harness the benefits of new technologies, support innovation and competition, while mitigating risks to consumers, market integrity and financial stability.

Diving into the future of regulatory development, the government has proposed a staged and proportionate approach to regulation, which is sensitive to risks posed, and responsive to new developments in the market. As part of its commitments to diversify its regulatory portfolio, the government is developing a Financial Markets Infrastructure (FMI) Sandbox to support firms wanting to innovate through the use of tokenisation and Distributed Ledger Technology (DLT) to provide FMI services. The consultation points out a need for sufficient flexibility to be built into the regulatory framework to allow regulators to adapt rules and requirements as international work in this arena continues to develop. It will also benefit from the agility that will be afforded to UK financial services legislation by the Future Regulatory Framework (FRF).

# FCA Market Watch 70th Edition

On 3 October 2022, the Financial Conduct Authority (FCA) published the 70th edition of its Market Watch newsletter.

The newsletter noted the following recent observations on transaction reporting:

## Transaction reporting

The FCA uses transaction reports from firms to oversee and regulate the markets. Since the implementation of MiFID II in 2018, the FCA has worked with firms to improve the quality of transaction reporting data.

However, there were concerns that many firms are not conducting sufficient checks on their data. The FCA also noted that some firms were providing breach notifications that included limited details and also references to internal reporting systems and processes.

The FCA re-iterated that breach notifications needed to be comprehensive, for example including examples of how fields were misreported and corrective measures going forward.

## National identifiers

The FCA noted that firms are required to obtain national identifiers to identify natural persons when onboarding clients. However firms, especially firms serving retail clients electronically, have been seen failing to conduct adequate due diligence.

Firms must not execute transactions for clients unless their identifier has been reviewed and validated. Firms should require explanations from clients who do not provide a national identifier.

## Principal firm

The FCA clarified that an appointed representative (AR) should be seen as its principal firm for transaction reporting purposes. It is the principal firm that should be identified and not the AR in the transaction report.

The FCA emphasised that principal firms are ultimately responsible for the submitting of complete and accurate transaction reports and for implementing an adequate systems and controls framework.

## Branch reporting

The FCA clarified that, in addition to the criteria in Article 3 of Regulatory Technical Standards (RTS) 22, other factors such as:

- location of the branch receiving an order form a client;
- branch overseeing the individual responsible for making investment and execution decisions; and
- branch whose membership is used for executing transactions on a trading venue,

should be considered when UK branches of third country investment firms are determining when execution is taking place.

UK branches of third country investment firms are expected to report whether the investment firm is covered by directive 2014/65/EU (Field 5, Table 2, RTS 22) with "TRUE".

## Other transaction reporting issues

Firms should use the "INTC" reporting convention correctly.

Trading venues should adopt processes to ensure the timely receipt of information from members.

Firms should use "XOFF" when transmitting an order to an executing broker who is executing the transaction on a trading venue and not the market identifier code.

When financial instruments, not admitted to trading/traded on a trading venue are being executed, the instrument full name should include a description of the financial instrument that was traded.

## Instrument reference data

The FCA noted that Article 27 of MiFIR requires trading venues to submit instrument reference data to the FCA for financial instruments admitted to trading or traded on their trading venues. Systematic internalisers (SI) are also required to submit instrument reference data for reportable instruments that are not admitted to trading or traded on a trading venue, in which they have opted to be an SI.

## Systems and controls

The FCA stated that trading venues and SIs should put methods and arrangements in place that enable them to identify incomplete or inaccurate instrument reference data (in compliance with Article 6(2) of RTS 23) and that enables them to review feedback files.

The FCA expect to be notified promptly by an "instrument reference data errors and omission notification form" where a trading venue or SI identifies incomplete or inaccurate instrument reference data in its submissions.

## Systematic internalisers

The FCA re-iterated that SIs should only report instrument reference data for instruments in which they are an SI and that are reportable either:

- as a financial instrument where the underlying is a financial instrument traded on a UK, Gibraltar or EU trading venue (Article 26(2)(b) of MiFIR); or
- as a financial instrument where the underlying is an index or basket composed of financial instruments traded on a UK, Gibraltar or EU trading venue (Article 26(2)(c) of MiFIR).

## Other instrument reference data issues

The correct ISO 10962 CFI codes issued by the relevant National Numbering Agency should be used when reporting instrument reference data under UK MiFIR (Field 3, RTS 23).

Trading venues and SIs should only populate the issuer or operator of the trading venue (Field 5, RTS 23) with their own legal entity identifiers when they are the ones creating or issuing the financial instrument.

Termination dates (Field 12, RTS 23) should be populated with the date and time the instrument is expected to cease trading.

When submitting data for instruments that are not commodity derivatives, trading venues should ensure that the commodities or emission allowance derivative indicator (Field 4, RTS 23) is populated FALSE.

# The human factor in artificial intelligence

## Joint Bank of England/FCA Discussion paper on AI and Machine learning.

Financial regulation is forever running to catch up with evolving technology. There are many examples of this: the Second Markets in Financial Instruments Directive (MiFID II) sought to make up ground on the increased electronification of markets since the introduction of MiFID I; policymakers in both the EU and the UK are at this very moment defining the regulatory perimeter around cryptoassets, more than a decade after the initial launch of bitcoin; and regulators first took action against runaway algorithms long before restrictions on algorithmic trading made it into regulatory rulebooks. Continuing this trend, on 11 October 2022, the Bank of England (BoE) and the UK Financial Conduct Authority (FCA) launched a joint discussion paper on how the UK regulators should approach the "*safe and responsible*" adoption of AI in financial services (FCA DP22/4 and BoE DP5/22) (the AI Discussion Paper), which is now open for responses. This follows the UK Government's Command Paper published in July 2022, announcing a "*pro-innovation*" approach to regulating AI (CP 728) across different sectors.

One strong theme that comes out of the AI Discussion Paper is that, notwithstanding the potential benefits of AI in fostering innovation and reducing costs in financial services, the human factor is key to ensure that AI is governed and overseen responsibly and that potential negative impacts on clients and other stakeholders are mitigated appropriately. The fact that the regulators are consulting on bringing the oversight of AI expressly within the scope of the UK Senior Managers and Certification Regime (SMCR) illustrates the importance of this human element, and that humans should continue to run the machines, rather than the other way around.

## Risks and benefits

The fact that applying AI to financial services brings both risks and benefits has been well-rehearsed, including in the June 2021 report from the Alan Turing Institute that was commissioned by the FCA and in the final report of the UK's AI Public-Private Forum (the AIPPF Final Report) published in February 2022. These risks and benefits stem from the very nature of AI and how it operates, compared to, say, a conventional algorithm with static parameters. Whilst the BoE and the FCA concede that there is no consensus on a single definition of AI, "*it is generally accepted that AI is the simulation of human intelligence by machines, including the use of computer systems, which have the ability to perform tasks that demonstrate learning, decision-making, problem solving, and other tasks which previously required human intelligence.*"[1] This is, of course, a technologically neutral definition; there are arguments both for and against a clear technical definition, and the AI Discussion Paper raises the question of how AI should be defined (if at all) by regulators. For example, the proposed EU Regulation on Harmonised Rules on Artificial Intelligence (the AI Act) casts the net widely as to what *technology* might constitute an "*AI System*"[2], with the result that it is likely to capture many existing systems, not necessarily limited to those that feature more advanced learning capabilities typically associated with AI.

When adopted responsibly, the Bank recognises that AI can potentially then outperform human beings in terms of speed, scale and accuracy of outputs. Whilst a conventional algorithm might continue to apply the same parameters, an algorithm augmented by AI might adjust those parameters in line with both traditional data sources as well as "*unstructured and alternative data from new sources (such as image and text data).*" As the regulators note, "*[w]hereas traditional financial models are usually rules-based with explicit fixed parameterisation, AI models are able to learn the rules and alter model parameterisation iteratively.*" This creates challenges for the governance and operational oversight of AI that

*1 Paragraph 2.10, AI Discussion Paper.*

*2 Article 3, draft AI Act.*

are more pronounced in relation to AI because there is more scope for unpredictable outcomes. It is also potentially more difficult to interrogate the reasons for a given decision driven by AI than it may be with a person (the so-called "black box" problem). Autonomous decision-making by AI has the potential to "*limit or even potentially eliminate human judgement and oversight from decisions.*"[3] For obvious reasons, eliminating oversight entirely is difficult to reconcile with existing governance and operational rules under both the FCA Handbook and the PRA Rulebook, which quite properly see an ongoing role for real, living people to play in ensuring the right outcomes for stakeholders.

## The human factor

The AI Discussion Paper highlights that the regulators' expectation is that firms using AI must ensure a "*sufficiently strong set of oversight and governance arrangements that make effective use of humans in the decision-making loop and review the accuracy of those arrangements.*" This concept of the "*human-in the loop*" – the level of human involvement in the decision loop of any given AI system – is a key focus of the AI Discussion Paper, and is a common theme to be found in guidance and nascent regulation from around the world.[4]

Regulators' expectations around human involvement in AI may apply at a number of levels, including:

- the **design** of the AI system, including defining the inputs and outputs of the system and how they are used, including "*identifying where an automated decision could be problematic*";[5]
- the **operation** of the AI system, including in the interpretation of system outputs and avoiding '*automation bias*', where staff "*accept automated recommendations or may be unable to effectively interpret the outputs of complex systems and falsely reject an accurate output*";[6]
- the **overall oversight and governance** of firms' use of AI. Here, the regulators expect that "*firms deploying AI systems need to have a sufficiently strong set of oversight and governance arrangements that make effective use of humans in the decision-making loop and review the accuracy of those arrangements.*"

A serious look at the governance of AI within any given firm may include consideration of where AI "*owners*" and "champions" sit within the organisation and whether (and when) they come together through central AI escalation points. Firms may also want to consider the triggers that would lead to particular projects being scrutinised by firms' ethics or other internal committees that have control over whether any given AI project is greenlighted. The management information (MI) that the governing body and other senior stakeholders would use to monitor both new and existing AI initiatives also merits serious consideration, in particular to ensure that AI is behaving as intended and that illegal bias does not creep into AI-driven decisions.

In certain cases, ensuring human involvement in particular decisions may be an express legal requirement, rather than merely a question of good governance. The Consultation expressly acknowledges that, as things stand, Article 22 of the UK onshored version of the UK General Data Protection Regulation (UK GDPR) "*restricts fully automated decisions which have legal or similarly significant effects on individuals to a more limited set of lawful bases and requires certain safeguards to be in place.*"[7] For this purpose, the UK Information Commissioner's Office (ICO) has insisted that this human input needs to be "*meaningful*", and that a decision does not fall outside Article 22 just because a human has '*rubber-stamped*' it. As noted in the Consultation, however, the UK Government is planning to reform this aspect of UK GDPR through The Data Protection and Digital Information Bill 2022-23, which is currently at the second reading stage in the House of Commons. In a similar vein, with the Consumer Duty being a key focus of the FCA, ahead of the Duty coming into force for new and open products on 31 July, 2023, it is inevitable that the FCA will increasingly look at AI through a lens of whether the use of AI results in a firm delivering "*good outcomes for retail customers*" in line with new Principle 12, as well as whether the use of AI achieves the consumer outcomes and complies with the cross-cutting rules in new PRIN 2A.

Looking beyond the UK, any firms with European operations will also need to consider the AI Act, which will regulate "*High risk AI Systems*", including certain tools used in financial services, for example to establish

*3 Paragraph 2.16, AI Discussion Paper.*

*4 Paragraphs 4.64 – 4.66, AI Discussion Paper.*

*5 Paragraph 4.64, AI Discussion Paper.*

*6 Paragraph 4.66, AI Discussion Paper.*

*7 Paragraph 4.65, AI Discussion Paper.*

creditworthiness. The AI Act is likely to impose a significant compliance burden on entities within its scope, central to which is human involvement in risk management. Firms will be keen to ensure their risk management and compliance operations relating to AI can be aligned practically where they face duality of regulation across different jurisdictions. Where there is an opportunity to comment on evolving law, regulation and regulatory enforcement practice – for example in response to the joint discussion paper – firms will no doubt wish to advocate interoperability of evolving requirements, even if full commonality of requirements is unlikely to be achievable.[8]

## Interactions with the SMCR

The Regulators acknowledge that "*[w]ithin the SMCR there is at present no dedicated SMF for AI.*"[9] Whilst responsibility for technology systems currently sits with the Chief Operations function (SMF24), the Chief Risk Function (SMF4) is expected to "*ensure that the data used by the firm to assess its risks are fit for purpose in terms of quality, quantity and breadth.*"[10] In addition, neither the SMF4 nor the SMF24 are required functions for core or limited scope SMCR firms, even if they are key members of the governing body for banks or insurers. Focusing on the SMF4 or SMF24 could therefore leave a potentially important gap in regulation, particularly considering smaller firms who may wish to offer AI-based advisory services, for example online via a platform. In addition, in firms of all sizes, business-line aligned SMFs will have direct responsibility for AI initiatives being developed within their particular business area but, depending upon the circumstances, may coordinate with other members of the governing body to a greater or lesser degree on their approach to AI within their perimeter of responsibility.

The AIPPF Final Report raised the question of whether responsibility for AI should be concentrated within a single individual or shared between several senior managers. The Discussion Paper floats the possibility of introducing a new dedicated SMF and/or a Prescribed Responsibility for AI specifically. Here, the regulators highlight the risk of a "*technology knowledge gap*" between those on the governing body – who will often not have direct experience of working on or overseeing AI projects – and those operating within firms' businesses who do.[11] This highlights a particular challenge of finding individuals with the requisite knowledge and experience to oversee AI initiatives, particularly at the senior level. A range of skills are likely to be necessary to ensure effective oversight, including data science and statistical skills to be able to determine if data curation is being operated in accordance with law and policy and to detect illegal bias, increasing demand for an already rare skill set. It is clearly, however, a challenge that the regulators expect firms to overcome, with the regulators emphasising that governing bodies need to have the diversity of experience and capacity to provide effective challenge across the full range of the firm's business. Tentatively, the BoE and the FCA propose that "*the most appropriate SMF(s) may depend on the organisational structure of the firm, its risk profile, and the areas or use cases where AI is deployed within the firm.*"[12] As ever, this is without prejudice to the collective responsibility of boards and the respective responsibilities of each of the three lines of defence.

The debate around adequacy of governance is not limited to the governing body itself. The regulators emphasise the importance that staff responsible for developing and deploying algorithms are competent to do so. One possibility they suggest to ensure this is the creation of a new certification function for AI, similar to the FCA's existing certification function for algorithmic trading. The algorithmic trading certification function extends to persons who:

- approve the deployment of trading algorithms;
- approve the amendment to trading algorithms;
- have significant responsibility for the management of the monitoring, or decide, whether or not trading algorithms are compliant with a firm's obligations.

In the interests of consistency, if nothing else, rationalising the regulators' approach to certifications of staff with responsibility for SI with staff responsible for algorithms has a degree of logic to it.

*8 DLA Piper will be supporting the International Regulatory Strategy Group (IRSG) and its members to coordinate IRSG's response to DP22/4/DP 5/22.*

*9 Paragraph 4.50, AI Discussion Paper.*

*10 SYSC 21.2.1(e)*

*11 Paragraph 4.47, AI Discussion Paper.*

*12 Paragraph 4.55, AI Discussion Paper.*

## International influences

It would be difficult to comment on any UK initiative on AI without comparing to other overseas initiatives, not least (on the EU side) the AI Act and its accompanying Directive on AI Liability (the AILD) both of which as drafted have wide extra-territorial effect. Neither the AI Act nor the AILD are financial services sector-specific, though will of course have key considerations for financial services firms using AI, not least where their AI initiatives may get categorised as "*High-risk AI systems*" for the purposes of those pieces of legislation. It is clear, however, that both the BoE and the FCA are thinking globally in their approach to AI and take inspiration from other AI initiatives beyond Europe's borders, including (amongst others) the Veritas Initiative from the Monetary Authority of Singapore (the MAS) – which seeks to enable financial institutions to evaluate their AI-driven solutions against the principles of "*fairness, ethics, accountability and transparency*" (FEAT), and in which many European, UK and US organisations are participating – and AI Principles developed by the Organisation for Economic Co-operation and Development (the OECD). Financial services activity is fundamentally global, and drawing on the best global ideas to produce a regulatory framework that is "best of breed" – and does not conflict with other global standards – is a sensible approach.

## Responses to the Discussion Paper

The Discussion Paper is open for comments until February 10 2023. Whilst a lot of good thinking will no doubt come out of the stakeholder engagement on the discussion paper, the overall direction of travel seems clear: the adoption of AI requires robust governance arrangements and human oversight within an organisation, with clear lines of responsibility, and any use of AI system without a 'human-in-the-loop' is likely to fall below the regulators' expectations. It is also clear that effective governance and oversight will require a new skill set, particularly in the second and third lines of defence, to close the knowledge gap between those using and deploying AI and those overseeing its use and deployment.

*DLA Piper will be supporting the International Regulatory Strategy Group[13] to prepare a response to the discussion paper DP5/22.*

13 www.irsg.co.uk.

# The Financial Conduct Authority consults on the UK Sustainability Disclosure Requirements

On 25 October 2022, the FCA launched its long-awaited consultation on the UK Sustainability Disclosure Requirements (SDRs), *Sustainability Disclosure Requirements (SDR) and investment labels* (CP22/20). This is the next step in the government's Roadmap to Sustainable Investing and a crucial framework to support the UK's transition to a net zero economy.

The consultation will be of interest to investors, asset managers and product manufacturers, and banks and other entities lending directly to sustainable initiatives and manufacturing the green assets that are ultimately distributed to end investors.

## At a glance

The proposals have some changes from those in the FCA's related discussion paper, DP21/4. The new rules fall into four broad categories:

- sustainable investment labels
- disclosure requirements
- naming and marketing rules (including an anti-greenwashing rule)
- rules for distributors

Categories 1, 2 and 3 apply to portfolio managers and fund managers who manage or market authorised funds and unauthorised AIFs.

Category 4 applies to firms that distribute authorised funds and unauthorised AIFs to retail investors.

The FCA is introducing a new "anti-greenwashing rule" which will apply to all regulated firms and will take immediate effect upon publication of the final rules (expected June 2023).

It is being considered whether the scope of the rules should be extended to regulated asset owners, financial advisers and overseas products.

## Sustainable investment labels

Three sustainable investment product labels will be introduced, to give consumers greater confidence in the products they seek to invest in. These proposed labels have changed since DP21/4 based on feedback that they should be simpler and clear for consumers to understand. The proposed labels are:

- **Sustainable Focus:** Invests mainly in assets that are sustainable for people and/or planet
- **Sustainable Improvers:** Invests in assets that may not be sustainable now, with an aim to improve their sustainability for people and/or planet over time
- **Sustainable Impact:** Invests in solutions to problems affecting people or the planet to achieve real-world impact.

Firms can choose whether to apply a label to their investment products. But if a firm wants to apply a label, it must first meet a set of objective threshold qualifying criteria. Firms will need to assess and apply the criteria at the various stages of product development, from initial due diligence, screening and product design stages through to management and oversight review and signoff for final marketing materials.

## Disclosure requirements

The new rules propose a range of disclosures aimed at giving consumers confidence in their product selection. Unlike the labelling regime, they will not be optional for in-scope products.

Here's a summary of the required disclosures:

- **Consumer-facing disclosures** – aimed at giving consumers clear, targeted information to help them make considered choices about their investments.
- **More detailed disclosures** – targeted at a broader range of stakeholders including institutional investors.
  - **Pre-contractual disclosures** – legally binding, static information for investors to make informed decisions about which products meet their needs and preferences.
  - **Sustainability product-level reporting** – on an ongoing basis, a dedicated sustainability product report, including key indicators and metrics, which builds upon the product report that is required to be aligned with the recommendations of the Taskforce for Climate-Related Financial Disclosures (TCFD).
  - **Sustainability entity-level reporting** – entity-level reporting that builds on the TCFD entity-level disclosure requirements, helping investors to understand how firms offer their products and are managing sustainability risks and opportunities.

The FCA has proposed rules and guidance on location, scope, format, content and frequency for the disclosures. With no templates to start from, firms must consider the guidance holistically and work through their customer journeys to ensure all communications and marketing materials are considered and the labels appropriately applied. We expect firms to work with industry bodies to create a market-standard approach to disclosure.

## Comparisons with other regimes

In the EU, the broadly equivalent regime, SFDR, is already partially implemented and becoming established. In the US, the Securities and Exchange Commission (SEC) made two ESG-related proposals in May 2022.

There's some overlap in the approach adopted under the SFDR and the SEC rules, but there are some key differences.

For example, the FCA is not proposing to introduce the EU principle of "do no significant harm" at this stage. Most fundamentally, the FCA is describing part of the SDR measures as a "labelling regime," whereas both the EU and SEC are at pains to emphasise that their rules are not a labelling regime (despite market practice).

## Naming and marketing

The FCA has proposed "naming and marketing" rules to protect consumers from greenwashing.

Notably, a new and general "anti-greenwashing" rule is being proposed, requiring sustainability-related claims be clear, fair and not misleading. This is proposed to apply to all FCA-regulated firms from 30 June 2023.

Though in the same vein as existing financial promotion requirements, the new anti-greenwashing rule is another tool in the FCA's enforcement toolkit, allowing it to challenge communication and marketing in a sustainability context in a manner we have increasingly seen from other agencies, such as the Advertising Standards Authority.

The FCA has expressed concern about firms making misleading or exaggerated claims regarding sustainability that it considers do not "stand up to close scrutiny." So we should expect enhanced supervision and scrutiny around firms' use of the sustainability labels – both now (under the "fair, clear and not misleading" principles) and even more so when the UK SDR is introduced.

We expect significant overlap between the naming and marketing rules in the SDR and the new Consumer Duty standards applicable to certain firms. Firms currently implementing the new consumer duty regime should consider how these requirements interact.

The FCA will consider separately whether the scope of the rules will be extended to overseas products. In the meantime, when the SDR rules are finalised, the FCA is proposing that overseas product communications containing prohibited sustainability terms should alert retail investors that the product is not subject to the FCA SDR regime, and include a link to the FCA webpage on SDR labelling and disclosure.

## Rules for distributors

Distributors must ensure that labels and consumer-facing disclosures are accessible and clear to consumers.

This builds on the FCA's July 2021 Dear CEO Letter to AFMs. The FCA acknowledges the breadth of intermediaries involved in distribution activities and the important role these participants have in communicating sustainability-related information to retail investors.

First, the FCA proposes that labels must be prominently displayed digitally or in other media. A label should be used only where the product has been assigned that label by a fund manager. Second, distributors would be required to keep any communications updated to reflect changes made to the label and consumer-facing disclosures.

## Securities lending, short-selling and derivatives

In this consultation, the FCA concludes neither securities lending nor short selling are inherently incompatible with ESG. The FCA is not proposing any specific constraint on the ability of strategies that involve securities lending to qualify for one of the FCA sustainable investment labels.

## Looking ahead

Firms must send any responses to the consultation by 25 January 2023. The FCA intends to publish final rules by the summer of 2023, with expected implementation as follows:

- **30 June 2023:** General "anti-greenwashing" rule
- **30 June 2024:** "Labelling," "Naming and Marketing," "Consumer Facing," "Pre-Contractual" disclosure requirements and rules for distributors
- **30 June 2025 onwards:** "Entity level" disclosures for the largest fund manager

In the meantime, firms should assess:

- which funds and products are in-scope
- which labels may be suitable (if any)
- what disclosures are required at the relevant entity level
- what information (and information rights from counterparties) will be required to support and evidence the use of the labels and disclosures

All regulated firms will need to review their sustainability communication and marketing communications to ensure they don't fall foul of the "anti-greenwashing" rule. Firms should expect FCA supervision and enforcement action in this space after the rules are implemented.

The FCA is expected to publish follow-up consultations on extending the scope of the SDR to include, for example, overseas products, certain insurance products, and financial advisors. It's also expected to give more guidance on the metrics to support the use of the label and on the location, content and form of disclosures.

We'll publish more on CP22/20 in due course. In the meantime, if you have any questions, please get in touch.

# European Union

# EU reaches provisional agreement on cryptoassets regulation (MiCA)

On 30 June 2022, the EU reached a provisional agreement on the landmark markets in cryptoassets (MiCA) regulation. This is a significant milestone for the future direction and structure of cryptoasset regulation in Europe.

MiCA sets out a comprehensive regulatory framework for a number of cryptoassets which currently fall outside the scope of EU regulation, such as certain unbacked cryptoassets and stablecoins. It captures cryptoasset issuers, as well as service providers, including trading venues and wallet providers.

The new requirements promote consumer protection, while also addressing other concerns relating to market abuse, financial stability issues as well as the environmental and climate impact of certain cryptoasset-related activities.

Notably, MiCA introduces a new authorisation regime for crypto-asset service providers who operate in the EU. It also establishes liquidity requirements for stablecoin issuers, including the obligation to put in place a 'sufficiently liquid reserve' (of a 1:1 ratio) in respect of stablecoin issuances.

The European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) will be responsible for the supervision of the new regime at EU-wide level.

The provisional agreement is subject to approval by the Council and the European Parliament before going through the final stages of the legislative process.

# ESMA Strategy 2023 to 2028

ESMA published a 5 year strategy document in October 2022 to cover the next 5 years.

The Paper sets three overarching strategic priorities for ESMA.

These are:

- Fostering effective markets and financial stability.
- Strengthening supervision of EU financial markets.
- Enhancing protection of retail investors.

The Paper also identifies two cross-cutting thematic drivers.

These are:

- Enabling sustainable finance.
- Facilitating technological innovation and effective use of data.

A strong overall message is that ESMA will continue to work closely with national competent authorities (NCAs) to improve closer cooperation and more standardised approaches cross-border.

## Fostering Effective Markets and Financial Stability

ESMA sees itself as a valuable source of technical knowledge regarding securities and markets regulation for NCAs and others such as the European Commission, the Council and the European Parliament.

A key focus will continue to be coherent implementation of markets related regulations through ESMA's convergence activities.

ESMA will focus in particular on enhancing market transparency through developing and operating the European single access point (ESAP) which will provide unique central access to all necessary regulatory information to facilitate investment in the EU.

ESMA will also implement the consolidated tapes to support more efficient price formation and allocation of capital.

ESMA will also strengthen further its risk assessment of securities markets to assist with assessing financial stability risk within the EU. A particular area of focus will be financial markets infrastructure through effective implementation of the CCP recovery and resolution regime.

ESMA will work over the next 5 years to contribute to the sustainable transformation of European markets and ESMA itself by building ESG factors into its own activities. It has applied for the Eco-Management and Audit Scheme certification and will reduce its environmental footprint.

It is also going to undertake significant digital transformation work to use data and technology more for its own work.

## Strengthening Supervision of EU financial markets

ESMA acts as a single supervisor for certain types of financial institution and as a coordinator with the NCAs regarding other types of financial institution.

ESMA plans to deepen cooperation on data collection and data sharing between NCAs and ESMA and to develop common analytics.

There will be a focus on risk based supervision and union strategic supervisory priorities (USSPs) will identify a limited number of high priority areas where more intensive EU supervisory tools will need to be used to achieve effective supervision. The key USSPs are not identified, however.

ESMA says they will also focus on supervisory issues with EU wide impact and also issues identified in a smaller set of Member States that might be systemic for the EU single market. This might, possibly, be a veiled reference to issues that have arisen in the Baltic States relating to AML and financial crime.

ESMA says it is increasingly focusing its convergence activities towards effective coordinated supervision but that it will still continue its efforts to ensure a consistent understanding and application of the EU single rulebook.

As regards situations where ESMA is the single supervisor it says that it will primarily focus on consolidating its established mandates i.e. it does not currently envisage significantly expanding its single supervisor role currently.



## Enhancing Protection of Retail Investors

A particular focus for ESMA will be effective information exchange between NCAs cross-border between home and host NCAs.

Another will be joint supervisory measures to support effective supervision and enforcement – including continuing the work of supervisory colleges and the use of delegation.

ESMA also plans to increase engagement with retail investors – with greater direct communication to retail investors by ESMA together with NCAs. ESMA warnings and statements will be made available so NCAs can customise them and send them out in their own jurisdiction – and there will also be more joint ESMA/NCA publications.

ESMA will continue to focus on retail information and disclosure with a view to helping investors make well informed investment decisions.

## Enabling Sustainable Finance

ESMA plans to support ESG transition by taking a holistic view across the length of the sustainable investment value chain.

A particular focus will be high quality disclosures and reducing the risk of greenwashing.

ESMA will also look to promote international cooperation with a view to having a coherent set of rules internationally.

## Facilitating Technological Innovation and Effective Use of Data

ESMA will work with the NCAs to assess the impact of technological innovation on the markets eg decentralisation, use of platforms, digitalisation.

ESMA will also work on developing detailed regulatory standards in relation to operational resilience as part of the implementation of the Digital Operational Resilience Act (DORA).

ESMA will look at risks to retail investors – particularly financial exclusion and risk of data abuse.

ESMA will step up the effective use of data across ESMA's activities and will strengthen its roles as a data and information hub in the EU. This will be particularly used to support NCAs work on financial supervision.

# Spain

# Changes to the Spanish collective investment undertakings and venture capital funds regulations

On 29 September 2022, the Law for the Creation and Growth of Companies was published. It introduced a set of reforms that seek to boost and improve collective investment and venture capital in Spain, amending Law 35/2003 (LIIC) and Law 22/2014 (LECR). These are the main amendments:

## LIIC – Regarding collective investment undertakings:

- Certain measures are introduced that will contribute to improve the competitiveness of the sector, such as the elimination of the mandatory quarterly report or the establishment of telematic means as the default form of communication with investors.
- European long-term investment funds (ELTIFs) are included among the funds that a Spanish management company (SGIIC) may administer, represent, manage, distribute and hold in custody. This type of vehicle was created to give retail investors access to investment in small and medium-sized unlisted companies, allowing them to invest in a type of asset (syndicated loans, private debt, stocks and shares and others) only available, until then, to institutional investors.
- SGIICs can be incorporated in the form of Limited Liability Companies (SL) which will provide greater flexibility in terms of the governance of these entities.

## LECR – Regarding venture capital entities and other closed-end collective investment undertakings:

- Retail investors could invest with a lower ticket, so as an alternative to the requirement of EUR100,000 of initial investment, it would be now possible to invest a minimum initial amount of EUR10,000 as long as the retail investors:
  - invest in accordance with a personal recommendation from a financial advisor; and
  - where the retail investors' financial assets do not exceed EUR500,000, the investment do not represent more than 10% of the assets.
- A new type of debt fund is created called "Loan closed-end collective investment undertakings" (EICCP). These are funds whose main purpose is to invest in invoices, loans, credit and commercial papers commonly used in the course of business. Their managers must comply with additional obligations and requirements aimed at guaranteeing adequate credit risk management.
- For the first time, Spanish venture capital entities could invest in debt instruments which could be part of their mandatory investment ratio of 60%.
- As it occurs with the LIIC, references to ELTIFs are included in the LECR. The ELTIFs will be registered in the relevant administrative registry of the Spanish Securities Market Commission (CNMV).
- The main purpose of the venture capital is broadened to allow investment in financial entities whose activity is mainly based on the application of technology to new business models, apps, processes or products.
- The legal investment diversification regime of venture capital entities is made more flexible to adapt them to the international standards and practices of the sector.
- It homogenizes Venture Capital Entities-SMEs with the figure of the European Venture Capital Funds, so the requirement that the target companies must have a maximum of 250 employees is made more flexible to raise this maximum to 499.
- The initial disbursement of venture capital companies is reduced from 50% to 25% of the committed capital.
- Closed-end management companies (SGEIC) can be incorporated in the form of SL providing greater flexibility in terms of the governance of these entities.

# CNMV Circular 3/2022 on the prospectus and the KID for Spanish funds

New CNMV Circular 3/2022, of 21 July regulates the prospectus of collective investment undertakings and the registration of the document containing the key investor information (the Circular).

- The new Circular regulates the form, content and presentation of the prospectus of collective investment undertakings (UCI), the causes and forms of updating, and the form in which it must be sent to the CNMV.
- It also eliminates from the content of the prospectus certain information that's not required by Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 (UCITS Directive) and that's already included in the key information document (KID) regulated by Regulation (EU) No 1286/2014 of the European Parliament and the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs Regulation), such as the current expenses indicator, the structured UCI return scenarios or the synthetic risk indicator, so the prospectus is simplified, avoids repetitions and is aligned with the prospectus of other countries.
- As far as the KID is concerned, the Circular refers directly to the form and content of the KID of PRIIPs Regulation and explains how the KID should be sent to the CNMV.

The new Circular repeals Circular 2/2013, of 9 May (except for four final provisions).

The Circular will enter into force on 1 January 2023, coinciding with the date of application of the PRIIPs Regulation to UCITS. The entities should send the KID of the UCI for its incorporation to the relevant CNMV registries before 31 January 2023.

# CNMV Public Consultation on the Code of Best Practices for Institutional Investors, Asset Managers and Proxy Advisors

On 24 June 2022, the CNMV launched a public consultation on the Code of Best Practices for Institutional Investors, Asset Managers and Proxy Advisors in relation to their duties with respect to the assets allocated or services provided (the Code).

The Code is what's known internationally as a Stewardship Code. It requires institutional investors, asset managers and proxy advisors to be transparent about their investment processes, engage with investee companies and vote at shareholders' meetings.

Main features of the Code:

- Voluntary nature (not mandatory): those entities that want to adhere to the Code should notify it in writing to the CNMV indicating its full corporate name, its LEI Code (if available) and whether they have decided to apply a transitional period (please see the last point below).
- With a general scope: applicable to institutional investors (ie pension funds, insurance and reinsurance companies), asset managers, proxy advisors and family offices, which, in principle, are based in Spain, although investors and managers based outside Spain may adhere to it too.
- The Code consist of seven principles focused, among others, on:
  - the need to have a deep knowledge of the companies in which they invest and to regular monitoring them;
  - the need to disclose the engagement policy; and
  - the exercise of voting rights, etc.
- For any type of asset.
- Apply and Explain: the entities that voluntarily adhere the Code should, in principle, comply with all and each of the Principles of the Code. Therefore, the Code adopts the "Apply and Explain" model, meaning that it will not be sufficient to merely state that a certain principle has been applied, but it must be explained:
  - how each principle has been applied and implemented in practice and to what extent;
  - what practical results and impacts have been produced; and
  - whether the established objectives have been achieved.
- Proportionality criterion. Each principle sets out possible ways of incorporating proportionality in its application.
- Transitional period: There is a transitional period of no more than three years where the entities can gradually comply the Principles of the Code and apply during that period the "Comply or Explain" principle instead of the "Apply and Explain" one, provided that they define a calendar and a plan explaining how they will comply with all the Principles at the end of the transitional period. If for any reason, at the end of such transitional period, all the Principles of the Code are not applied in their entirety, the entity must declare it as such and may no longer declare its adherence to the Code.

Comments to the Code has been already received by the CNMV and we're waiting for the publication of the final version.

# Belgium

# Cryptoasset regulation in Belgium

The Financial Services and Markets Authority (FSMA) has published a consultation on the legal qualification of cryptoassets and new supervisory powers regarding the commercialisation of virtual currencies.

More and more attention has been given to cryptoasset regulation in Belgium since the beginning of the year. Following the introduction of a specific regulatory framework dedicated to the provision of certain cryptoasset services in Belgium earlier this year (read our alert on the topic here), the Financial Services and Markets Authority (FSMA), one of the two supervisory authorities of the Belgian financial sector, has drawn up a communication on the classification of cryptoassets as securities, investment instruments or financial instruments. In addition, a legislative act of July 2022 also granted new supervisory powers to the FSMA regarding the commercialisation of virtual currencies.

## FSMA consults on the legal qualification of cryptoassets

### CONTEXT

Due to an increased interest in cryptoassets in Belgium, the FSMA has been frequently questioned about the legal qualification of cryptoassets and services related to cryptoassets.

Granting the appropriate legal qualification to cryptoassets — while not easy – is essential to identify which regulatory framework may be applicable to ensure compliance with regulatory requirements. Some cryptoassets may already qualify as transferable securities under Directive 2014/65[1] (MiFID II) or electronic money/e-money under Directive 2009/110[2] (EMD II). At EU level, Regulation (EU) 2022/858[3] (the DLT Pilot Regime) adopted in June 2022 also clarifies that financial instruments under MiFID II may be issued by means of distributed ledger technology (such as blockchain), which means that security tokens qualify as MiFID II financial instruments.

However, even where cryptoassets can fall within the scope of EU legislation, effectively applying it to these assets is not always straightforward. Additionally, most cryptoassets currently fall outside of the scope of EU legislation on financial services. These would, however, in the future, be subject to the Markets in Cryptoassets Regulation, currently under adoption at EU level.

In the meantime, and until European regulatory harmonization is achieved, questions remain on the legal qualification of cryptoassets and the objective of the FSMA Communication is to provide explanations on the most common cases where cryptoassets may fall within the scope of application of financial regulations.

### POSSIBLE LEGAL QUALIFICATIONS OF CRYPTOASSETS

By focusing on the questions and situations which it has encountered most frequently, the FSMA has drawn up a stepwise plan (accessible here) setting out the most common situations and offering a series of schematically presented guidelines for the exercise of classifying cryptoassets under three possible legal qualifications:

- securities within the meaning of Regulation 2017/1129[4] (Prospectus Regulation);
- investment instruments within the meaning of the law of 11 July 2018 on public offers of investment instruments[5] (Prospectus Law); and
- financial instruments within the meaning of the law of 2 August 2002.[6]

1 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), OJ L 173/349, 12 June 2014.

2 Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC, OJ L 267/7, 10 October 2009.

3 Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology, and amending Regulations (EU) No 600/2014 and (EU) No 909/2014 and Directive 2014/65/EU, OJ L 151, 2 June 2022.

4 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, OJ L 168/12, 30 June 2017.

5 Law of 11 July 2018 on public offers of investment instruments and the admission of investment instruments to trading on a regulated market, Belgian Official Gazette, 20 July 2018.

6 Law of 2 August 2002 on the supervision of the financial sector and on financial services, Belgian Official Gazette, 4 September 2002.

In case of issuance of cryptoassets incorporated into instruments, the following qualifications are possible:

- **Qualification of cryptoassets as securities:** if cryptoassets are transferable instruments and represent a right to share in the profits or losses of a project and potentially a voting right, or a right to payment of a sum of money or an equivalent, these cryptoassets are, as a rule, considered to qualify as securities within the meaning of the Prospectus Regulation. So the requirement to publish a prospectus or an information note under the Prospectus Law might be of application.
- **Qualification of cryptoassets as financial instruments:** if cryptoassets are transferable instruments and represent a right to share in the profits or losses of a project and potentially a voting right, or a right to payment of a sum of money or an equivalent, these cryptoassets also qualify as financial instruments, so that MiFID rules of conduct would apply.
- **Qualification of cryptoassets as investment instruments:** if cryptoassets are non-transferable instruments and represent a right to share in the profits or losses of a project and potentially a voting right, or a right to payment of a sum of money or an equivalent, these cryptoassets are classified in principle as investment instruments under the Prospectus Law. In addition, if the cryptoassets represent a right to the delivery of a service or a product by the issuer and have an investment objective, the instruments are classified, as a rule, as investment instruments within the meaning of the Prospectus Law. Either case may trigger the requirement to draw up an information note or a prospectus. The Communication provides for several aspects to consider whether the instruments have an investment objective, such as their transferability to other persons that the issuer or the fact that the issuer intends to trade them on a market and has an expectation to profit.

## POSSIBLE APPLICATION OF ADDITIONAL FINANCIAL REGULATIONS

Where cryptoassets qualify as securities, investment instruments or financial instruments, then in addition to compliance with applicable requirements of the Prospectus Regulation, the Prospectus Law or MiFID rules (as the case may be), there is the potential impact to be considered of additional legislation that may apply, such as the rules governing market abuses or crowdfunding.

In cases where instruments are not issued by an issuer but are created by an informatic code that does not give rise to a legal relationship between two persons (such as bitcoin or ether), then in principle the Prospectus Regulation, Prospectus Law and the MiFID rules of conduct will not be applicable.

Nevertheless, even if a thorough analysis leads to the conclusion that given cryptoassets do not legally qualify as securities, investment instruments or financial instruments, this does not preclude the possible application of additional specific regulations. For example, if the instruments have a payment or exchange function, the rules applicable to virtual assets services providers may still be applicable. In addition, the prohibition of marketing financial products whose return depends directly or indirectly on a virtual currency to retail investors may also apply.

The FSMA itself acknowledges that the stepwise plan does not address all potential legal classifications and cannot replace a full legal analysis based on all characteristics and features of cryptoassets and the project. It advises against reliance solely on the name of a cryptoasset when legally qualifying it, since the label does not necessarily match the content.

## NEXT STEPS

The FSMA held an open consultation in July 2022 on the Communication and welcomed responses from the financial services sector. Based on the input received, the FSMA may amend its stepwise plan, which is likely to evolve over time.

At EU level, the legislative process to establish a framework applicable to the provision of cryptoasset-related services is still ongoing. Provisional agreements were reached at the end of June 2022 on the proposal for a Transfer of Funds Regulation and on the proposal for a Markets in Cryptoassets Regulation.

## New supervisory powers granted to the FSMA relating to virtual currencies advertising

On 19 July 2022, the Act of 5 July 2022 containing various financial provisions (Omnibus Act) was published in the Belgian State Gazette, which includes amending certain provisions of the existing Act of 2 August 2002 on the supervision of the financial sector and financial services (Financial Supervision Act). New supervisory powers granted to the FSMA regarding the promotion of virtual currencies to non-professional investors are of special note.

### CONTEXT

In the past few years, virtual currencies (such as bitcoin) have been widely promoted to the general public through multiple channels, which has generated increasing interest from investors. Notwithstanding the many success stories that have been booked within the crypto scene, several sanctions have recently been imposed against certain personalities active on social media (so-called influencers) who promote cryptoassets to their followers on social media in disregard of the law (eg misleading advertising and fraudulent practices).

**Lack of regulation on cryptoassets advertising**

While the legislative process on the adoption of a comprehensive framework for the regulation and supervision of issuers and providers of services for cryptoassets is still ongoing at EU level, initiatives relating to cryptoassets are happening in Belgium, including a specific regulatory framework dedicated to the provision of certain cryptoasset services.

However, until recently, a legal framework on the commercialisation (and advertising) of virtual currencies among non-professional investors was lacking. Hence, there was no guarantee for Belgian and European investors that the information provided to them was correct, clear and not misleading.

**ESA warning on cryptoassets**

In March 2022, after a surge in aggressive advertising promoting cryptoasset without provision of proper information, including through social media, the three EU supervisory authorities (the European Banking Authority, the European Securities and Markets Authority and European Insurance and Occupational Pensions Authority) published a joint warning to consumers on the risks of cryptoassets.[7] The authorities

7 European Supervisory Authorities, EU financial regulators warn consumers on the risks of crypto-assets, ESA 2022 15, March 2022.

specifically alerted consumers to the risks of misleading advertisements related to investments in cryptoassets, including via social media and influencers and advise consumers to be particularly wary of promised fast or high returns.

**National initiatives related to cryptoassets advertising**

Following the ESA's warning, several national financial regulators moved to regulate cryptoasset advertising, with an eye on their promotion on social media.
In allowing the FSMA to regulate the advertising of virtual assets to non-professional investors, Belgium is following the example of regulatory initiatives in other countries (including Spain, the UK, and recently France), aimed at curbing malpractices within the sector.

## NEW SUPERVISORY POWERS

To address the risks of incorrect and fraudulent advertising of virtual currencies towards non-professional investors with limited knowledge and experience, the Omnibus Act amends the Financial Supervision Act to extend the scope of competences of the FSMA relating to the commercialisation of virtual currencies.

As a result, the FSMA will be entitled to impose restrictive conditions on the commercialisation to non-professional customers of virtual currencies or certain categories of virtual currencies and to supervise compliance with those requirements.

**Material scope of application**

The supervisory powers of the FSMA relate to the "commercialisation of (certain categories of) virtual currencies." Commercialisation should be understood as "the presentation of the product or currency, regardless of how it is done, in order to induce the client or potential client to purchase, subscribe to, join, accept, sign for or open the relevant product or currency."
Given the broad scope of the definition, advertising via social media would qualify as commercialisation for purposes of the Financial Supervision Act.

**Personal scope of application**

The concept of "client" should be understood in the broad sense and applies irrespective of the capacity of the person offering the products (issuer or not) and the relationship between that person and the retail client concerned (contractual or not).

This means that people who act as intermediaries, commission agents or brokers, or who, like so-called influencers, limit themselves to making promotions, in exchange for some remuneration or benefit, for products that they do not themselves issue or dispose of, would also be targeted by the legislation.

**Territorial scope of application**

The rules laid down by the FSMA would apply only to commercialisation attempts directed at Belgium. The Preparatory Works of the Omnibus Act clarify in this respect that the use of personalities who are "well known" in Belgium, or the use of marketing arguments specific to Belgium, would, for example, make it possible to demonstrate the existence of a link with Belgium.

Finally, it should be noted that the new FSMA supervisory powers come on top of the existing prohibition to market financial products whose return depends directly or indirectly on a virtual currency to retail investors.

## IMPACT

It's expected that the regulations would improve the quality of information provided to potential investors, and would allow verification that investors are well-informed about the risks associated with the purchase of virtual currencies. Following the amendment, the Financial Supervision Act will now also contain the (currently lacking) legal basis for the FSMA to penalise malicious actors who target non-professional investors, where they do not comply with the applicable regulations.

## NEXT STEPS

The provision of the Omnibus Act extending the supervisory powers of the FSMA for virtual currencies advertising entered into force on 29 July 2022. It's now up to the FSMA to issue more detailed rules by way of a regulation.

Our Fintech and Financial Services team is constantly monitoring the evolution of the Belgian and European regulation around cryptoassets and is happy to assist you with any query you might have.

# The Netherlands

# DNB fines Binance for violating the registration requirement for crypto service providers being active in the Dutch market

On 25 April 2022, the Dutch Central Bank (*De Nederlandsche Bank*, "**DNB**") published its administrative fine that it imposed on Binance Holding Limited ("**Binance**") for violating the registration requirement for crypto service providers under the Dutch AML Act (*Wet ter voorkoming van witwassen en financieren van terrorisme*) and the obligations under the Dutch sanctions Act (*Sanctiewet 1977*).[1]

This article will briefly discuss the enforcement actions that DNB imposed on Binance and it will summarize the key arguments of DNB. This article is of interest for market participants who are interested to enter the Dutch crypto market.

## Dutch registration regime for crypto service providers

### DUTCH REGISTRATION REGIME

Since May 2020, the Dutch AML Act (*Wet ter voorkoming van witwassen en terrorismefinanciering*) which is an implementation of the 4th Anti-Money Laundering Directive, requires crypto service providers to register with DNB when offering certain crypto services.
The registration requirement was introduced since these services pose a potential high risk of money laundering or financing terrorism given the current anonymity when trading these products.

There are two types of crypto services that are within the scope of the registration requirement. These are '*exchange services to exchange virtual currencies for fiduciary currencies or vice versa*' and '*providing of custodian wallet services for virtual currencies*'.

In the Netherlands, crypto service providers are required to register with DNB when these services *are (a) provided in a professional capacity or on a commercial basis* and (b) *from the Netherlands*. In practice this means the following:

Ad (a) *provided in a professional capacity or on a commercial basis*

In order to qualify as an activity to be carried out *in a professional capacity or on a commercial basis*, DNB considers relevant, among other things, that

(i) the activity is not provided incidentally and must more than just occasional; This means that the activity must be performed systematically or regularly. Incidental or one-time activities are insufficient to qualify as professional or commercial. A qualifying feature of the systematic or regular frequency is whether the provider advertises for these services or provides these to multiple customers.

(ii) the provider receives remuneration, or any other kind of compensation or income is generated from it. It is not relevant whether these activities are profitable or the main activity of the provider

Ad (b) *from the Netherlands*

In order to qualify as *providing these services in the Netherlands*, the DNB highlighted in its administrative fine to Binance the elements it deems relevant.
The circumstances which DNB took into consideration are:

- having a website in the Dutch language, with a Dutch language option in the desktop version;
- offering the online payment method 'IDeal';
- providing the app in the app store in the Dutch language, and
- providing a Dutch newsletter.

Also, activities such as hosting a webinar about tax return and cryptos or social media posts in the Dutch language are taken into account. These are considered to be circumstances to actively offer services, with a view to win consumers over as customers.

1 The administrative fine is publicly available via the website of DNB (link) in Dutch only.

If your company is conducting the above activities while offering crypto exchange or wallet services you should consider whether your company should be registered with DNB for such services.

### ENFORCEMENT BY DNB

Being the world's largest crypto exchange is one of the circumstances DNB took into consideration to determine the fine to Binance at EUR3.3 million. DNB considered Binance as a global crypto service provider and to be positioned to be informed about applicable laws, regulations and restrictions to which Binance's trading is subject and Binance had to be aware of the registration with DNB in the Netherlands. The violation in this case was punishable by the imposition of an administrative fine with a minimum of EUR2 million which was increased with 50% due to Binance's global position and the level of culpability of Binance. The fine was slightly lowered due to its transparent cooperative attitude about its business operation and the pending application to register with DNB and to become compliant since.

## A call for action

Practice has shown that DNB is monitoring market activity in the crypto space actively and that DNB will enforce the Dutch AML Act requirements actively as well. The Binance case is a warning to market participants to be mindful about the registration requirement in the Netherlands and to ensure that Dutch clients are not onboarded if you are not duly registered with DNB.

Notably, market participants should also be aware of the risk that failure to register as a crypto service provider qualifies as an economic offence under the Dutch Economic Offences Act (*Wet op de economische delicten*) and DNB may report this offence to the Public Prosecutor's office.

# US

# FedNow: Federal Reserve issues new rules to facilitate instant payments

The Federal Reserve Board has issued new rules to provide the regulatory framework necessary to support an interbank real-time gross settlement service with integrated clearing functionality. Known as the FedNow Service, it's to be available on a 24x7x365-basis and will support instant payments in the US. According to its 19 May announcement, the Board hopes to bring the FedNow Service online in 2023. Effective 1 October 2022, the rules will be included as a new subpart to Regulation J (12 C.F.R. part 210), which has traditionally provided the regulatory framework for the collection and return of checks through the Federal Reserve System (subpart A) and the terms and conditions governing funds transfers over the Fedwire Funds Service (subpart B).

- One feature of new subpart C is its incorporation of the provisions of Article 4A of the Uniform Commercial Code, or the UCC, to transfers over the FedNow Service, to the extent that these provisions are not otherwise inconsistent with the Board's rules. The Board based the decision to do so on the belief that the benefits of such a structure outweighed the burdens of needing to determine whether, and to what extent, a particular transaction may be governed by one or more provisions found in UCC Article 4A, the Electronic Funds Transfer Act (EFTA) or the Board's FedNow Service rules. These benefits included the ability for financial institutions to be protected from consequential damages (unless provided otherwise in express written agreement), which is believed to reduce costs associated with the speedier transactions. To the extent that a transfer conducted over the FedNow Service is also an "electronic fund transfer" under the EFTA, the provisions of both subpart C and the EFTA would govern, with the EFTA prevailing over any inconsistency – providing a level of consumer protection to immediately settled consumer transactions.
- Although the primary objective of the new rules will be to provide real-time funds availability, the Federal Reserve did not define what it means to provide funds "immediately." In an effort to speed up settlement, the rule limits instances where a beneficiary's bank may request additional time to determine whether to accept a payment order only to instances where the bank has a reasonable basis to believe the beneficiary is not entitled or permitted to receive the payment. Examples of these situations discussed in the rule's commentary include situations where the recipient may be barred by US sanctions or where there is known fraudulent activity.
- Finally, the Fed will continue to work with industry stakeholders to refine and address erroneous or misdirected payments. Currently, the sending bank has 60 calendar days after notice that a payment order has been accepted or that its settlement account was debited to inform a Federal Reserve Bank of facts concerning unauthorized or erroneously executed payment orders for purposes of UCC Article 4A.

# FDIC issues draft climate risk management principles

The FDIC has issued draft principles providing guidance as to how large financial institutions should manage financial risk related to climate change. Published in the *Federal Register* on 4 April FDIC's Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions is intended to offer "a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the risk management framework described in existing FDIC rules and guidance and are intended to support efforts by financial institutions to focus on the key aspects of climate risk management." While FDIC's Financial Institution Letter is primarily targeted at banks with over USD100 billion in total consolidated assets, the agency notes that "all financial institutions, regardless of size, may have material exposures to climate-related financial risks." The proposed guidance seeks to address "weaknesses in how financial institutions identify, measure, monitor, and control the financial risks associated with a changing climate" that "could adversely affect a financial institution's safety and soundness, as well as the overall financial system." In a 30 March statement, acting FDIC Chair Martin Gruenberg said he expects additional guidance will have to be issued "that provides clear supervisory expectations regarding the application of each of the general principles" recently announced. Gruenberg said, "the proposed Statement of Principles represents an initial step" and the agency "plans to elaborate on each of these principles" in a manner "appropriately tailored to reflect differences in financial institutions' circumstances, including size, complexity of operations, and business model."

# New York DFS issues guidance for stablecoins

The New York state Department of Financial Services (DFS) on 8 June released new guidance on the issuance of USD-backed stablecoins. Baseline criteria include the requirement that stablecoins be fully backed by a reserve of assets and redeemable by investors. Issuers of stablecoins must adopt redemption policies approved in advance and in writing by DFS, and the reserve assets must be segregated from the proprietary assets of the issuing entity and be held in custody with federally – or state-chartered depository institutions and/or asset custodians. The reserve will have to consist of the following assets:

- US Treasury bills acquired by the issuer three months or less from their respective maturities;
- reverse repurchase agreements fully collateralized by Treasury bills;
- Treasury notes and/or bonds on an overnight basis, subject to DFS-approved requirements concerning overcollateralization; and
- deposit accounts at chartered depository institutions.

In addition, the reserve will be subject to an examination at least once per month by an independent, licensed CPA. The guidance also reminds issuers they are still subject to other regulation and oversight regarding cybersecurity, Bank Secrecy Act/anti-money-laundering compliance, consumer protection, and safety and soundness. DFS Superintendent Adrienne A. Harris noted that New York has been a national leader in this emerging regulatory space and said the new guidance "creates clear criteria for virtual currency companies looking to issue USD-backed stablecoins in New York."

# Canada

# The road to CORRA: Sunset on CDOR

Refinitiv Benchmark Services (UK) Limited (RBSL) marked one of the biggest changes to Canadian financial markets in recent memory when it announced that it would permanently stop publishing the Canadian Dollar Offered Rate (CDOR) by 28 June 2024.

As the primary interest rate benchmark in Canada for over 40 years, CDOR is referenced in over CAD20 trillion of gross notional exposure across the Canadian financial system. Organizations whose financial instruments currently reference CDOR have less than two years to adjust to this change, which may be particularly challenging for those that lack adequate fall-back language. Without this language, financial instruments may be unclear as to which rate applies, or may fail to reference a valid benchmark rate altogether once CDOR ceases.

## The White Paper

RBSL's announcement was partly in response to the Canadian Alternative Reference Rate Working Group's (CARR) white paper (the White Paper), released on 16 December 2021. The White Paper determined that CDOR, as it is currently structured, is not a sustainable long-term benchmark. CDOR applies far more broadly than the data that underlies it, and is based on expert judgement rather than observable arms-length transactions. This construct lacks transparency and is inconsistent with the global shift towards transaction-based approaches. Further, CDOR's reliance on the bankers' acceptance (BA) market may become increasingly eroded as fewer banks voluntarily submit rates, given the increased costs and obligations to do so.

The White Paper also found that it was unfeasible to enhance or reform CDOR, so it proposed the following: RBSL cease calculating CDOR after 30 June 2024, and Canada implement a two-stage transition to the Canadian Overnight Repo Rate Average (CORRA).

## Transition to CORRA – the Roadmap

While CORRA has not been confirmed as the next benchmark rate in Canada, it is largely predicted to replace CDOR as the next Canadian risk-free overnight reference rate. Based on actual market transactions in the Government of Canada's repo market, CORRA is administered by the Bank of Canada and closely follows the Bank of Canada's policy rate.

However, unlike CDOR, CORRA lacks a risk and term component, meaning an additional benchmark may be required for certain loan and hedging agreements. In response to this concern, CARR has introduced a consultation to determine the need for Term CORRA, which would be limited to one-month and three-month tenors. This consultation could lead to Term CORRA's introduction in Q3 of 2023.

The first phase of CARR's recommendation provides that all new derivative contracts and securities should transition to CORRA by 30 June 2023, with no new CDOR exposure after that date. This excludes derivatives that reduce CDOR exposures, securities transacted before 30 June 2023, or loan agreements transacted before 30 June 2024.

The second phase provides for the continuation of CDOR-based loans until 28 June 2024, provided they have robust fall-back language. During this period, loans can reference CORRA in arrears, Term CORRA, or any other available alternative rate. After 28 June 2024, no new CDOR rates will be published and any exposure will revert to the CDOR fallbacks.

## How the transition to CORRA will proceed

The transition from CDOR is a significant task that requires financial contracts, systems, and process to migrate to an alternative reference rate on a tight timeline. However, CARR has attempted to facilitate this transition by addressing the difficulties that can arise when a major benchmark is changed without adequate fallback language, as was the case following LIBOR's cessation in the US. CARR therefore released its recommended fallback language in August of 2022, to be used in new and existing loan documentation that currently reference CDOR. This will ensure that contracts contain robust benchmark rates following CDOR's cessation.

## Overview of fallback language

This loan fallback language is entirely voluntary, and can be amended as required. The following is an overview of the recommended language:

| Element | Recommendation |
|---|---|
| Hardwired Approach | • CARR does not recommend an "amendment approach", and instead expects CDOR loan products to transition to CORRA. It therefore published language that incorporates a fallback to CORRA to promote the development of a market convention for this transition. |
| Trigger | • Once CDOR's publication ceases on June 28, 2024, loan agreements with CARR's recommended language will automatically transition to the benchmark replacement rate.<br>• Note that additional conforming changes will be necessary, such as removing banker's acceptance mechanics and adding them for CORRA-based loans. |
| Two-Step Benchmark Replacement | • CARR's, language recommends the following two-step waterfall to determine the successor rate to be used to replace CDOR at the cessation date:<br>1. Term CORRA + credit spread adjustment: and<br>2. CORRA Compounded in Arrears + credit spread adjustment.<br>• The recommended language is released ahead of Term CORRA's release. If CARR's, consultation shows a need for Term CORRA, it could be released by Q3 of 2023. However, there is no guarantee it will be publish by CDOR's cessation date. Because of this, CARR provides for a fallback to CORRA compounded in arrears which can be "flipped forward" in cases where CDOR has initially been replaced with CORRA Compounded in Arrears, and Term CORRA is subsequently released. |
| No Early Opt-In | • The recommended language does not include a right to opt into CORRA ahead of CDOR's cessation date, making an amendment necessary should parties wish to do so. |
| BAs and CORRA Loans | • Given how interconnected CDOR is with BAs, CARR's language recommends moving away from the issuance of BAs entirely.<br>• Any rollovers from a loan to a BA would become ineffective, and would instead be deemed a CORRA loan request. All outstanding BAs would continue to maturity.<br>• CORRA loan mechanisms must be added to the loan agreement. |
| Credit spread adjustments ("CSA") | • CARR's recommended language includes hardcoded CSAs to account for economic differenced between the replacement rate and CDOR.<br>• Once CDOR ceases to be published, CARR expects the market to transition to CORRA plus a spread without the need for a credit spread adjustment. |
| Non-Standard Borrowing Powers | • CARR's recommended language does not include standard mechanics for addressing nonstandard interest periods.<br>• Borrowers and lenders should therefore determine their required mechanics and incorporate their own language if needed. |

## Going forward: Parties' next steps

Parties should consider including the CARR recommended language in financial instruments, either through amendments or by creating new documents. Parties should be sure to modify the language as necessary to conform to the specifics of their agreements.

Parties to loan agreements, where borrowing is done under a BA facility, should also note that CARR's recommended language is not to be relied on to transition contracts from CDOR to CORRA. Parties must also include CORRA loan mechanisms to their loan agreements ahead of CDOR's cessation.

Market participants should also monitor market developments, as CARR's recommended language is subject to change.

# International

# FSI Paper on Big Tech Regulation

On 3 October 2022, the Financial Stability Institute published a paper entitled "Big Tech Regulation: In Search of a new framework."

The paper noted that technology innovation in the financial services market had led to the rise of a new group of large providers of digital services such as Alibaba, Tencent or Rakuten (Big Techs). These Big Techs have been gaining market share in sectors such as digital payments services and credit and wealth management.

The Big Techs have been able to take advantage of creating a common infrastructure and collecting large amounts of client data in order gain a competitive advantage in non-financial and financial services. Their business models rely on synergies between commercial and financial activities which can result in an over-concentration of financial services providers. In addition, traditional financial firms have increasingly been reliant on technology services provided by the Big Techs such as cloud computing services, data analysis or credit scoring. All of these factors mean that the Big Techs represent potential risks to fair competition, market integrity, consumer protection and financial stability.

## Regulatory challenges

The regulatory challenge is that there is no comprehensive regulatory framework surrounding the Big Techs. The applicable regulations will look at specific subsidiaries in specific sectors and do not consider the overall risks posed by the whole Big Tech group.

## Segregation

One potential approach to the regulation of the Big Techs is segregation. This would see financial services be separated from non-financial services. Big Techs may be required to establish financial holding companies that would group all financial companies under one entity and ring-fencing regulations would be created to control this entity's interdependence with the rest of the Big Tech group.

It is noted that while this approach may be effective and efficient at mitigating risks, interdependence is one of the main competitive advantages of Big Tech. There is a danger that this approach may stifle innovation by dissuading the Big Techs from offering financial services.

## Inclusion

An alternative approach is inclusion. This approach would create a new regulatory category for Big Tech and new regulations would consider the whole group not just subsidiaries in regulated sectors. Interactions between the group's financial and non-financial activities would be regulated by group-wide requirements.

It is suggested that this approach would be more likely to encourage Big Tech to continue to innovate in the finance sector while still minimising the risks. However, the paper recognises that the requirements may become a disproportionate regulatory burden to groups depending on how the regulations are implemented.

## Conclusion

The increased participation of the Big Techs in providing financial services is a source of new opportunities and new risks. Their unique business model based on network externalities has created difficult policy challenges that are not adequately covered by the current patchwork of sector-specific regulations. Both the segregation and inclusion approach have their benefits and drawbacks in developing umbrella regulation for Big Techs operating in the finance sector. Ultimately, regardless of which approach is chosen, the international community will need to establish global regulatory guidance to address the risks that the Big Techs pose to the financial industry.

# The crypto crash: A catalyst for further crypto litigation?

An earlier version of this article first appeared in the September 2022 issue of Butterworths' Journal of International Banking and Financial Law.

## Introduction

In recent years, the cryptoasset market has developed rapidly, with market capitalisation for cryptoassets estimated to have been around USD2.6 – 3 trillion in 2021.[1] The market for decentralised finance (DeFi), although still relatively small, has also expanded quickly from less than USD10 billion in 2020 to nearly USD100 billion in 2021.[2] However, over the last few months the cryptoasset market – specifically cryptocurrencies – has been seeing one of its worst selloffs since a market rally in 2020. This has sparked panic amongst investors, causing substantial financial losses. Inevitably, this has seen a flurry of litigation globally in recent months. This trend is likely to continue. We consider the causes of the crypto crash and the likely litigation risks for financial institutions and advisers.

## The 'Crypto Crash'

The recent crypto crash appears to have resulted from three main causes:

First, many economists consider that the interest rate cuts by the Federal Reserve in the US in early 2020 resulted in inflation which in turn drove prices upwards, particularly in the cryptocurrency markets. However, the recent interest rate increase in May 2022 to curb inflation appears to now have had the opposite effect, causing investors to become nervous about a potential recession and leading to a mass exodus from digital assets.

Second, the collapse of the "stablecoin" TerraUSD in May 2022 (a stablecoin which was pegged to the US Dollar 1:1) and its sister coin Luna caused panic amongst investors. Large Luna holders "cashed out", causing the supply of Luna tokens to increase and, therefore, its price to crash. This, in turn, caused the smart contract algorithm (as intended) to create more Luna to re-establish the peg leading to further downward pressure on the price of Luna.

Third, as crypto prices have plummeted, this has prompted other investors (usually younger, less sophisticated and more fickle investors who are more susceptible to hype and social media manipulation) to panic and sell their assets, perpetuating the losses and, in turn, the crypto crash.

## Key Litigation Risks

Given the scale of the losses suffered, it is likely that investors will be seeking to recoup their losses by commencing litigation. We consider below some of the potential types of claims and/or litigation risks for financial firms/advisers arising out of the crash.

- Social media has played a significant role in fuelling interest and hype over crypto assets. Coupled with the lack of regulation in the crypto markets, it is likely that consumers that have lost money through cryptocurrency investments will seek to bring mis-selling claims, particularly in relation to misleading ads on social media. In particular, investors are likely to bring claims relating to certain types of cryptoassets eg "stablecoins" which were seen or promoted as being "safe" or low risk investments given they were pegged to flat currency. In the US, class actions have already commenced against Kim Kardashian and Floyd Mayweather for alleged misleading cryptocurrency posts on Instagram. In the UK, the Advertising Standards Authority has, to date, required more than 50 crypto firms to review their ads to ensure proper compliance with advertising rules.

1 https://www.coingecko.com/.

2 https://www.bankofengland.co.uk/speech/2021/october/jon-cunliffe-swifts-sibos-2021.

- Investors are also likely to consider claims against financial advisers for alleged failures in connection with cryptocurrency portfolios. Investors could potentially argue that financial advisers either breached their duty of care by acting negligently by advising/recommending and/or investing in unsuitable cryptoassets which have ultimately led to financial losses or made untrue, unclear or misleading statements.
- Given the dramatic loss of value of cryptoassets, investors may seek to bring claims against crypto platforms and/or exchanges in circumstances where their trading position(s) may have been closed due to a lack of collateral and/or exposure on a trading account. It is likely that investors may allege they did not have adequate opportunity to provide additional margin prior to the closure of their trading position(s) which resulted in losses.
- The unregulated nature of cryptoassets means that there will be greater suspicion arising out of unforeseen losses by investors. There is a risk therefore that investors are likely to bring market abuse claims, alleging manipulation of cryptocurrency prices by exchanges, perhaps through artificial price inflating tactics (eg through the sale/ purchase of crypto assets) and/or dissemination of false information.

## Practical Tips

Financial institutions operating in the crypto sector should consider the following:

- Review and ensure that they have robust AML, surveillance and security processes to mitigate the risks of market abuse claims from investors.
- Review carefully any statements or representations made in relation to the success or likely returns from cryptoassets.
- Incorporate basis and/or non-reliance clauses into their T&Cs and contractual documents to make clear that no advice is being provided to and/or being relied upon by the end customers.

# In Focus

# The Financial Services and Markets Bill 2022: A second 'Big Bang'?

On 20 July 2022, the Financial Services and Markets Bill 2022-23 (the Bill) was introduced into Parliament. At over 330 pages, the Bill is the largest piece of financial services legislation since the Financial Services and Markets Act 2000 (FSMA) was passed more than two decades ago.

Before the Bill was introduced into Parliament, government sources indicated that we should expect a second 'Big Bang' to echo the wide-ranging deregulatory changes introduced in 1986. Whilst many of the proposed changes to onshored Single Market legislation are indeed liberalising in nature, the main proposals were long expected, and the bigger story is the extent to which the government itself is seeking to exert greater control over regulatory standards. Following the first Big Bang, liberalisation of foreign ownership rules led to widescale consolidation of ownership of UK brokerages, with many legacy firms being bought out by US banks and other international firms. This time around the debate is again about ownership, but this time it is ownership of regulatory policy that is the focus, rather than ownership of firms themselves. This extends not just to ownership of rulemaking powers by the UK rather than the EU, but also the desire for HM Treasury to have greater control over post-Brexit rulemaking by the PRA and the FCA.

## Balance of powers

Unusually, the focus on the eve of the Bill's publication was on what isn't in the Bill, rather than what is. In his speech at Mansion House on 19 July 2022, the then Chancellor of the Exchequer, Nadim Zahawi, confirmed that the much-rumoured new "call-in" powers allowing ministers to intervene in regulators' decisions "*in the public interest*" have not made it into the Bill. The Chancellor stated that he was "keeping an open mind" as to whether such powers were appropriate, but the sensitivity of such proposals were clear, bearing in mind the extent to which the Bank of England and the Prudential Regulation Authority (PRA) value their independence, something that was made very clear by the current Governor of the Bank of England in his own Mansion House speech the same evening.

Notwithstanding the absence of the call-in powers, the Bill does, however, contain a number of provisions that are cut from the same cloth. The Bill would introduce a new obligation under Section 3RA of FSMA for each UK regulator to keep their rules under general review, and if a regulator either fails to do so (or else proposes to do so in a way that HM Treasury does not view as "*appropriate*"), the Treasury can appoint an independent third party to review the regulator's rules for them. In addition, the proposed new secondary objective for the FCA and the PRA to facilitate the growth and international competitiveness of the economy of the United Kingdom – "*including in particular the financial services sector*" – is designed to foster a more "UK PLC" approach to the discharge of regulatory obligations, including in the development of rules. Whilst some commentators have suggested that a new competitiveness objective could lead to a 'dangerous' refocusing away from financial stability, the objective has been framed in such a way that it would not require either the PRA or the FCA to act in a way that is inconsistent with their primary objectives – which include protecting the stability of the UK financial system – so these concerns are arguably overstated, even if they do introduce more creative tension into the UK rulemaking process.

## Prudential standards – Reforming Solvency II

A key purpose of the Bill, as championed by the Chancellor, is that it will enable the UK to proceed with its plans to reform Solvency II and move towards a Solvency UK regime. The Government wants to reduce the risk margin insurers are required to include in their technical provisions to take account of the additional cost of transferring their liabilities to a willing third party. It wants to increase the range of assets available for the "matching adjustment" they are able to apply where they have liabilities with predictable outflows (eg under annuities), and change the calculation of the "fundamental spread", which seeks to reflect the risk of default or downgrade represented by the matching adjustment assets. More generally it is looking to reduce a range of EU-derived reporting, administrative, and other regulatory requirements. The Government hopes its package of reforms will mean that around 10-15% of the capital currently held by UK life insurers can be released allowing them to put tens of billions of pounds into long-term productive assets (eg green infrastructure projects), whilst safeguarding policyholder protection. Other hoped for advantages include reducing the incentives for UK insurers to reinsure internationally – so premium is retained in the UK economy – and reducing the cost to UK consumers of, in particular, long-term insurance products like annuities.

These proposed changes continue the same theme, insofar as they show the government's willingness to reform regulatory standards to ensure UK competitiveness, noting that here, HM Treasury are not just thinking about the insurance sector themselves, but about freeing up capital and delivering benefits for the real economy, and ultimately for consumers. The focus for the Government is perhaps obvious. The UK's needs around infrastructure spending and the green transition more generally, are too significant to have disproportionate amount of capital locked away in lower risk assets, and there is a strong political imperative to demonstrate gains from post-Brexit regulatory freedom. The PRA in particular will be keen to ensure that the dial does not move too far away from financial prudence and that the new liberalising mindset does not sow the seeds of the next financial crisis.

## Future Regulatory Framework (FRF)

Sections 3, 4 and 5 of the Bill contain broad powers for HM Treasury to modify or restate retained EU onshored legislation and replace legacy references to EU directives. It is clear that there is a cosmetic angle to this as well as a functional one, with an eye on the usability and comprehensibility of legislation. One of the criticisms of the process of onshoring EU legislation in advance of the UK's exit from the EU Single Market was that it left behind a relatively complex web of complex interpretive provisions and cross-referencing. That the Treasury now has the power to amend onshored legislation and related references to EU directives for "*the purpose of making the law clearer or more accessible*" will be welcome to many working in the regulated sector, and should be welcomed by customers as well, if it allows them to more easily navigate the protections from which they benefit.

## Wholesale markets

As regards the proposed changes to primary and secondary markets, there are fewer surprises; in many cases, the proposals in the Bill match the changes to primary legislation that have already been identified by the Treasury as being necessary to implement the UK's Wholesale Markets Review and the UK Listings Review, although in the secondary markets space it is notable that matters previously baked into primary legislation are instead being delegated down to either HM Treasury or the FCA, which is in keeping with the Chancellor's theme of agile regulation. This can be seen in giving the FCA power to frame waivers from post-trade transparency requirements, via a replacement Article 4 of the UK onshored Markets in Financial Instruments Regulation (MiFIR), as well as giving the FCA rulemaking power over both pre- and post-trade transparency requirements for both fixed income instruments and derivatives. It is worth noting that there is no such discretion in respect of the UK Share Trading Obligation (STO) – the Bill would delete the STO directly, along with most of Article 23 of UK onshored MiFIR, leaving behind only the requirement for firms that operates an internal matching system which executes client orders equities and equity-like instruments on a multilateral basis to get authorised as an MTF.

That these changes are expected, of course, does not make them unwelcome; wholesale banks and investment firms will welcome the liberalisation of the UK secondary markets – including the renewed focus on achieving the best outcomes for investors – even if their enthusiasm will be tempered by potential commercial and operational drag against conflicting EU provisions. The UK is now out of the EU Single Market, but their financial markets remain fundamentally connected, and the question of how to build the best regulatory environment for the UK without creating undue operational or commercial headaches in respect of cross-border activity remains an ongoing challenge.

## Other changes

To quote the Chancellor's Mansion House speech, "*[t]hat's not all the Bill does*." A range of other familiar and less familiar proposals that have made their way into the Bill include:

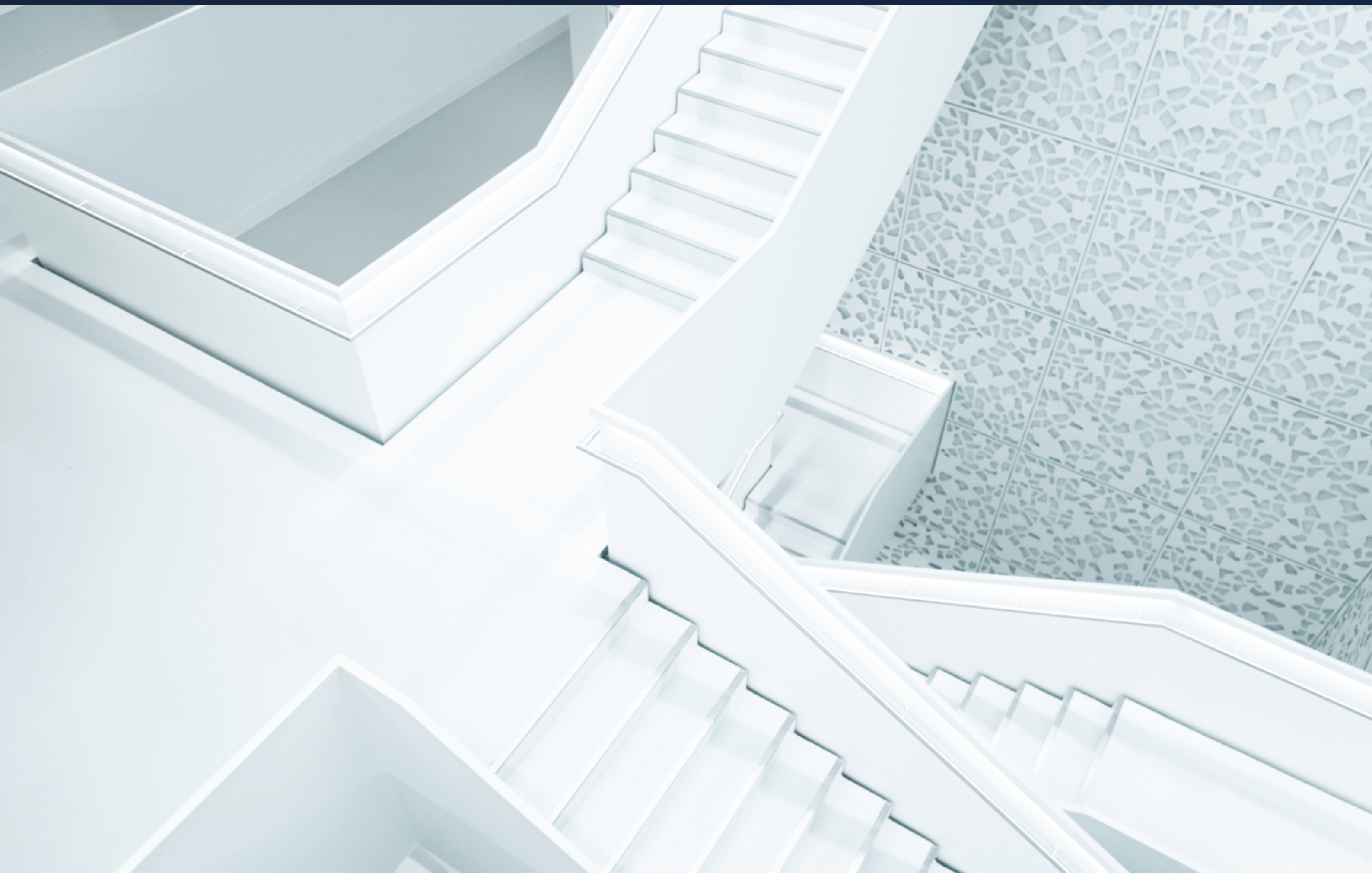
- **Financial markets infrastructure (FMI) sandboxes** – Section 13 of the Bill would give HM Treasury a new power to introduce financial markets infrastructure (FMI) sandboxes under secondary legislation to allow "*testing, for a limited period, the efficiency or effectiveness of the carrying on of FMI activities in a particular way*." Section 15 would in turn allow HM Treasury to make the sandbox arrangements permanent, either as tested or with such variations as HM Treasury consider appropriate. This new power will be particularly welcome to pioneers in digital and other alternative trading, clearing or settlement offerings whose operations do not fit neatly into existing regulatory criteria and/or legacy Single Market rules designed for a pre-digital era.
- **Critical third parties** – Technology services such as cloud computing and data analytics bring multiple benefits such as enabling digital transformation and catalysing innovation. However, increasing sector reliance on a small number of key third parties does create a degree of concentration risk across the market that needs to be managed. Section 18 of the Bill would introduce a new Chapter 3C to FSMA to help implement HM Treasury's 8 June 2022 policy paper on Critical third parties to the finance sector, which is aimed at the leading cloud services providers and certain other key non-regulated financial sector intermediaries on which the regulated sector relies. This includes an express power to censure persons designated as critical third parties where they breach rules made by the FCA, PRA or Bank of England in connection with the services they provide to authorised persons, as well as the broad powers of direction, information gathering and investigation set out in HM Treasury's paper. The proposals stop just short of formally bringing the main cloud services providers into the UK regulatory perimeter, but it certainly brings them closer.
- **Changes to financial promotions rules** – As expected, the Bill contains changes to the ability of authorised persons to approve financial promotions prepared by third parties that don't hold a UK authorisation, eg affiliates based overseas who undertake business with UK customers on a pure-cross border basis in reliance on exemptions under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the RAO). The Bill would introduce a new Section 55NA of FSMA which requires authorised persons to obtain a specific permission from the FCA in order to approve such communications. These changes are closely linked to HM Treasury's review of the Overseas Framework and should assist in helping to prevent the UK's financial promotions regime being misused by firms with a nominal footprint in the UK who may promote riskier products to UK customers without adequate levels of control or oversight.
- **Net zero emissions target** – Section 25 of the Bill will add the need to contribute towards achieving compliance with the UK net zero emissions target set out in the Climate Change Act 2008 (as amended) to the list of regulatory principles to be applied by both the PRA and the FCA, as set out in Section 3B of FSMA.
- **Settlement of crypto assets** – Section 22 of the Bill contains a new power for HM Treasury to introduce bespoke rules on the regulation of payments, payment systems and service providers in relation to the payments that include "*digital settlement assets*", which includes any digital representation of value or rights, whether or not cryptographically secured, that "*(a) can be used for the settlement of payment obligations; (b) can be transferred, stored or traded electronically, and (c) uses technology supporting the recording or storage of data (which may include distributed ledger technology)*." This should allow the government to place payments technology that relies on distributed ledger technology or other forms of cryptography – as well as novel payment technology using other digital methodologies – to be put on a clearer regulatory footing, thereby helping to support the UK as a recognised centre for digital technology in the financial services space. These changes should allow certain types of stablecoin to be regulated as a form of payment in the UK, which in the view of the Treasury could facilitate stablecoins becoming a widespread means of payment, thereby driving customer choice and efficiency and cementing the role of the UK as a leading player in the crypto space.
- **Access to cash** – Against a background of the growth of digital payments, we should not lose sight of the fact that many in society prefer a more analogue lifestyle. With this in mind, the Bill would require the Treasury to publish a statement of policy concerning cash deposit and withdrawal services and designate certain firms – including current account providers meeting criteria set out in the Bill – as firms providing

those services, with a view to ensuring the continuity of access to cash services through directions to firms so designated. These proposed new provisions in FSMA can be found in Schedule 8 of the Bill and align with recommendations made following the consultation on access to cash held by the Treasury during 2021.

- **Protecting against authorised push-payment (APP) scams** – Following the consultation by the UK Payment Systems Regulator (PSR) in November, 2021 on how to significantly reduce APP scam losses incurred by payment system users, the Chancellor confirmed in his Mansion House speech that the Bill contains powers that "*enables regulators to require that victims of push payment scams are paid back*." In particular, Section 61(1) of the Bill requires that the PSR "*must prepare and publish a draft of a relevant requirement for reimbursement in such qualifying cases of payment orders as the Regulator considers should be eligible for reimbursement*." In addition, in keeping with the overall theme of the Treasury taking the reigns of regulatory rulemaking, Schedule 7 of the Bill contains detailed new provisions on the accountability of the PSR, including a proposed new Section 102A of FSMA that would empower the Treasury to make recommendations to the PSR on (amongst other things) how to advance one or more of its payment systems objectives and exercise its regulatory functions. Notably, this is a power that must be used: Section 102A of the Bill provides that the Treasury must make recommendations in relation to the PSR's payment systems objectives in particular "*at least once in each Parliament*." It may be worth noting, in this context, that critics have contended that the powers should not be used against banks who can show they have identified scams before warning and informing customers.

## Next steps

The Bill will now progress through Parliament during 2023. In the meantime, other key elements of the reforms are being progressed on parallel tracks, including the FCA's consultation on equity secondary markets reforms that was published on 5 July 2022.



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