LATHAM & WATKINS

10 Key Focus Areas

for UK-Regulated Financial Services Firms in 2022

Focus Areas

In last year's publication, we highlighted the top regulatory focus areas for UK-regulated financial services firms during 2021, ranging from the impact of Brexit to the latest expectations on conduct and culture.

This publication outlines the primary focus areas for 2022. There has been a marked shift away from dealing with immediate post-Brexit priorities to more fundamental consideration of the direction of travel of UK financial services regulation, and this is borne out across many of the topics covered in this year's publication. Further, relatively new topics such as climate change and environmental, social, and governance (ESG) issues are increasingly significant for financial services firms, and are likely to remain so for some time.

Scroll through or select a topic below

1 ESG

Key dates

- 1 January 2022: Disclosure obligations under the EU Taxonomy begin to apply; FCA TCFD-aligned climate-related disclosure regime for asset managers and asset owners comes into effect for the largest firms
- Q1 2022: Consultation expected on technical screening criteria for the first two environmental objectives under the UK Green Taxonomy
- Q2 2022: FCA Consultation Paper on SDR and product labels expected
- Q3/4 2022: FCA Consultation Paper expected on prudential ESG disclosures
- 1 January 2023: EU SFDR Level 2 measures take effect

Environmental, social, and governance (ESG) considerations have come to the forefront of firms' regulatory change agendas in recent years, and this focus looks set to continue in 2022. The past year has witnessed significant ESG-related developments in terms of policymaking at both national and international level, and firms now have clearer expectations of the standards they will need to comply with, although many requirements are still under development. While the EU had been a global leader in introducing ESG-related disclosure requirements, COP26 acted as a catalyst for other jurisdictions to announce new measures in this area. Of particular note, whereas previously there was little ESG-related material emanating from the US, under the Biden Administration the US has begun to develop its own expectations around ESG issues. The deluge of developments around the world has challenged global businesses to stay abreast of various ESG-related measures and expectations, and the pace of change is unlikely to slow in 2022. Further, while much of the focus to date has been on climate-related issues, regulators and other bodies are starting to consider the wider ESG criteria. A key watchpoint for firms will be the extent to which international standards emerge, as having uniform standards globally would significantly ease the compliance burden.

UK Developments

ESG has been a key focus in the UK in 2021. There have been numerous policy developments, and the FCA has demonstrated the importance it places on ESG issues by creating a new Director of Environment Social and Governance role. The FCA has further developed its disclosure regimes based upon the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). An extension of the FCA's existing requirements for premium listed issuers to standard listed issuers, and new disclosure requirements for asset managers and asset owners, came into effect on 1 January 2022 (although the latter will not apply to smaller asset managers and asset owners until 1 January 2023). The first disclosures under these regimes will not emerge until 2023, so there is still some time before such disclosures become commonplace, although a considerable number of entities already make voluntary TCFD-aligned disclosures. The FCA and HM Treasury have also indicated that they will consider in 2022 whether, and if so how, to regulate ESG ratings and data providers.

The UK government published its roadmap on sustainable investing in October 2021, setting out key dates in relation to the development of the UK's Sustainability Disclosure Requirements (SDR) and a UK Green Taxonomy. This

was followed by an FCA Discussion Paper on the SDR and product labels. The FCA will publish a Consultation Paper suggesting concrete policy proposals in the second quarter of 2022. It is proposed that the SDR will apply to corporates, asset managers, and asset owners, and will require disclosure in relation to sustainability matters more broadly (not just concerning climate issues). It will include the concept of "double materiality", requiring firms to disclose both financial materiality (i.e., how ESG issues impact the value of a fund's assets) and the impact that the firm and its products are having on the environment and on society.

The FCA is also proposing a product labelling system for all investment products that are available to retail investors, although it is yet to specify which products should be caught. However, the FCA intends this system to cover products regardless of whether they make sustainability-related claims. A key consideration in developing these proposals will be how they overlap with the EU Sustainable Finance Disclosure Regulation (SFDR). The FCA is mindful of the need to ensure a level of consistency, but is also conscious that SFDR was not intended to create a product labelling system. Therefore, the FCA notes the UK advantage of intending to create such a system from the outset. The FCA has also indicated that it expects to see firms engage with its policy proposals, and has suggested that this may be used as a benchmark for how seriously firms are considering ESG-related issues.

The UK Green Taxonomy will follow a similar approach to the EU Taxonomy and will include an identical set of six environmental objectives. The Green Technical Advisory Group, an independent body established in June 2021, will develop a set of technical screening criteria (TSC) that will underline each of the six environmental objectives. TSC for climate change mitigation and climate change adaptation objectives will be subject to consultation in Q1 2022, with legislation due to be drafted later in 2022, whilst the remaining four TSC are scheduled for consultation in Q1 2023. This follows the approach of the EU Taxonomy, which released TSC for climate change mitigation and climate change adaptation in advance of the other four objectives.

The FCA has focused not only on the "E" in ESG throughout 2021, but is also pursuing policy objectives in relation to diversity and inclusion. For more on this topic, please see section 5, below.

Following the PRA's introduction of supervisory expectations for the management of climate-related financial risks in April 2019, the regulator has continued to focus on the risks posed by climate change to PRA-regulated firms, and firms' progress in managing these risks. In order to ensure that firms are meeting expectations, the PRA has incorporated climate-related financial risks into its ongoing supervisory assessment process, such that firms will be actively supervised against these expectations and will need to demonstrate continued compliance.

EU Developments

In the EU, there will be further progress on the implementation of the SFDR and the EU Taxonomy throughout 2022. The TSC for the first two environmental objectives under the EU Taxonomy are in place, so related disclosures can commence. Also in place are technical

1 ESG

continued

standards on the Article 8 disclosure requirements. The European Commission is due to report back in 2022 on a potential extension of the environmental objectives in the EU Taxonomy, and on the creation of a social taxonomy, following reports published by the Platform on Sustainable Finance in July 2021.

However, the SFDR Level 2 measures, which contain the crucial detail on how firms are to comply with the main requirements, have been delayed yet again and are now not expected to apply until 1 January 2023. Therefore, there may be further confusion and inconsistency in 2022 about how the regime should be applied.

The European Commission also published proposals in November 2021 for a European Single Access Point (ESAP). The ESAP will offer a single access point for public financial and sustainability-related information about EU companies and EU investment products, including information disclosed under SFDR and the EU Taxonomy Regulation. The intention is for the ESAP to be operational from 31 December 2024, and it is hoped that this will result in more easily accessible ESG-related information in the EU.

Global Developments

Various initiatives have been introduced to set out global standards on ESG-related matters. Although global standards generally are not binding, the hope is that they will be adopted internationally to create a degree of harmonisation and therefore comparability across disclosures.

The International Financial Reporting Standards (IFRS) finally announced the long-awaited formation of the International Sustainability Standards Board (ISSB) in November 2021. The ISSB has committed to issue a set of IFRS Sustainability Disclosure Standards, which will provide investors with information on ESG metrics. The aim is to create an authoritative global standard that is widely adopted. The UK government has indicated that the ISSB will form a key pillar of the UK's future ESG reporting regime, discussed above.

IOSCO has also created sustainability-related regulatory and supervisory expectations in the asset management sector, as well as a set of recommendations applicable to ESG ratings and data product providers. The latter are likely to come under increased regulatory scrutiny in 2022 as market participants focus on the accuracy and reliability of ESG data.

2 Regulatory Divergence

Key dates

- Early 2022: HM Treasury to set out responses and next steps on the Wholesale Markets Review
- Q1&2 2022: FCA to consult on changes to its Handbook resulting from the Wholesale Markets Review
- 2022: EU legislators to consider the European Commission's proposals for revisions to various EU regulatory frameworks, including MiFID II, CRD IV, and the AIFMD

It is now clear that the EU and the UK are amending legislation separately, in a non-coordinated way, and effectively heading off on different paths. Most EU reforms are planned updates. Some UK reforms are deliberate policy changes to EU rules that the UK never liked. In 2022, divergence likely will occur to a greater degree, and more quickly, than had previously been anticipated. For purely domestic UK firms, this will look like no more than another set of regulatory reforms. For firms operating on a cross-border basis, the picture will be much more complex. An ongoing challenge for firms will be the extent to which they need to keep abreast of two separate sets of changes, depending on the location of their clients, when keeping on top of one was already a hard enough job.

There have been pockets of divergence so far, but with so many reviews underway on both sides there are likely to be numerous areas of divergence that firms will need to monitor. We set out some examples of these below. While the UK strategy seems to be focused on attracting business by removing areas of regulation that have long been seen as overly burdensome, the EU appears to be set, to a certain extent, on pursuing a somewhat protectionist agenda. Examples include the European Commission's proposals to tighten the third-country regime for banks accessing the EU, and proposed revisions to the AIFMD rules on delegation.

Capital Markets

The UK made clear during 2021 that achieving equivalence was no longer the aim, and the government and the FCA published proposals for once-in-a-generation reform to the regulation of UK markets. The FCA has already implemented new rules for SPACs and changes to the listing regime. Further reforms benefitting UK markets are expected in 2022, with reports due on HM Treasury's prospectus regime consultation, the UK Secondary Capital Raising Review, and the FCA's consultation on the functioning of the UK listing regime. While the UK would have been free to make at least some of these changes pre-Brexit, there is a new impetus to position the UK as an attractive prospect for firms seeking to do business.

MiFID II

Anyone who has grappled with comparing the similar, but not identical, MiFID "quick fix" changes in the EU and the UK will understand the headaches that regulatory divergence can cause. This looks set to continue during 2022, as HM Treasury plans to outline its next steps on the Wholesale Markets Review. The UK is proposing significant changes, and the government has confirmed

2 Regulatory Divergence

continued

that it will legislate "as early as parliamentary time allows" to revoke the share trading obligation and the double volume cap, recalibrate the transparency regime for fixed income and derivatives markets, reduce the scope of the position limits regime for commodity derivatives, and transfer the setting of position limit controls from the FCA to trading venues. The FCA will also consult on any required amendments to its rules to effect these changes.

Meanwhile, the European Commission has published its reform proposals for MiFID II. The main focus in the EU is on establishing a consolidated tape, rather than making the sorts of headline-grabbing reforms that the UK is pursuing. The EU approach is generally to tweak and amend, rather than to strike out areas of regulation that have not necessarily worked as intended. While the UK changes could feasibly be in place by the end of the year, the nature of law-making in the EU means that the EU proposals are likely to take longer to agree and implement.

MAR

The EU and the UK made similar minor revisions to MAR in 2021, but each jurisdiction may diverge more substantially in their approach during 2022. Although the approach under MAR is not usually controversial amongst regulators, we are likely to see different guidance from regulators and industry groups that will leave market participants facing a degree of uncertainty. New EU guidance does not apply in the UK (unless the FCA explicitly states otherwise), and so UK firms may feel unsure about how to approach the new ESMA guidance on pre-hedging that is expected this year.

Further, the outcome of the EU MAR Review, and any review undertaken in the UK, could lead to divergence. Each market is quite different and ultimately the regime will be adapted over time to suit the nature of the market. There may be different approaches to how the regime should develop and what it should cover. For example, ESMA has not recommended including spot FX within scope of MAR, but this could be something the UK considers. Moreover, under the EU's Markets in Crypto-assets Regulation proposal, cryptoassets would be brought into scope of MAR, whereas the UK is not proposing to do so for the time being.

3 The FCA's New Ethos

"The FCA must continue to become a forward-looking, proactive regulator. One that is tough, assertive, confident, decisive, agile."

Nikhil Rathi, FCA CEO

After less than a year at the helm of the FCA, Nikhil Rathi set out his vision for the regulator along with the latest Business Plan in July 2021. Mr Rathi spoke of a regulator that is "tough, assertive, confident, decisive, agile", and of a culture that embraces risk and acts decisively. He also stated that the FCA would be prepared to "test our powers to the limit". This reflects minutes from an FCA board meeting in April 2021, which recorded that the board supported proposals to recalibrate the degree of legal risk the FCA is willing to take.

Seemingly, the FCA is prepared to tackle more hard cases, even if it may not always win those cases. This new attitude is already evident in firms' interactions with the FCA, and will continue in 2022.

Authorisations

The FCA is under a great deal of political pressure not to allow repetition of past scandals that have resulted in consumer detriment, or to allow new business models to create future scandals. Consequently, the FCA is particularly focused on authorisations and new business, including authorisation applications by firms using the temporary permissions regime. The regulator is planning to bolster its authorisations department and has indicated that it will apply more scrutiny when a business is seeking authorisation in a complex area or for high-risk business (offering cryptoasset firms as an example). Businesses are already experiencing long wait times in the authorisations queue as a result of the FCA taking a more thorough approach; how the FCA will balance this approach with its current workload remains to be seen.

Decision-making and Enforcement

The FCA seems unafraid to take on difficult cases, and to reach potentially contentious outcomes. It has also made changes to a number of its rules in order to facilitate this new approach. For example, the FCA has made changes to its decision-making process, to transfer certain decisions from the Regulatory Decisions Committee to senior management within the FCA. While the FCA has branded this change as a way of making the process quicker and more efficient, the change has raised significant concerns about firms and individuals experiencing a fair process. The FCA's decision to go ahead with these proposals as consulted on was striking, particularly in light of the feedback it received to the consultation. The FCA has also been granted new powers that allow it to cancel regulatory permissions that are not being used under an

3 The FCA's New Ethos

continued

expedited process, which again raises questions about due process. How the FCA makes use of these new powers and the impact they have on firms will become evident throughout 2022.

Preventing Harm

In addition to reforming aspects of its supervisory powers, the FCA is focusing on trying to control potential areas of harm on a timely basis, in light of recommendations from the government. For example, buy-now pay-later products will be brought within scope of FCA regulation in response to a surge in businesses using this model, which currently falls within an exemption from the consumer credit regime. The FCA is also taking action to strengthen the appointed representatives regime and ensure that principal firms are supervising their appointed representatives effectively.

Individuals

Besides having implications for how firms interact with the FCA in 2022, the FCA's new ethos and assertive approach are likely to flow through into how firms handle regulatory and compliance matters internally. In particular, this is likely to manifest in how firms deal with culture and conduct issues, and in terms of fitness and propriety assessments. The FCA has taken on some difficult senior manager cases recently, and is taking a firm line on non-financial misconduct. This may cause firms to adopt a more cautious approach to dealing with issues concerning individuals, for fear that the FCA will take a strict line with the firm and potentially with any senior managers responsible for making the relevant decisions. However, firms should remember the need for a fair and balanced approach and should not be trying to second-guess the FCA.

How the FCA will marry its ambitions with its current capacity remains to be seen. The regulator is experiencing staffing issues in some areas and waiting times for many regulatory processes are going up. The FCA has also taken on greater responsibilities post-Brexit, so it appears to lack the bandwidth to cover all of the ground required.

4 Future Regulatory Framework Review

Key dates

- 9 February 2022: Future Regulatory Framework Review consultation closes for comment
- 2022: HM Treasury expected to set out feedback and next steps

HM Treasury is keen to make progress on the structure of UK regulatory reform. The Future Regulatory Framework Review is not intended to make specific policy changes, but rather is designed to adjust the UK regulatory architecture to reflect the expanded role of the UK regulators post-Brexit and to ensure that this structure is fit for purpose.

Firms are unlikely to be troubled by some of the proposed changes in the current consultation, for example adding to the regulators' objectives to reflect sustainable growth and international competitiveness seems sensible but hardly ground-breaking. Firms are also unlikely to see much of interest in the proposals that relate to the regulators' interactions with and accountability to Parliament, although they may question how the FCA in particular will manage to meet these increased demands given its current resourcing levels and expanding service times.

Approach to Onshored Legislation

In large part, the focus of the Future Regulatory Framework Review is the proposed method for transferring onshored EU legislation into PRA and FCA rules. HM Treasury believes that the current model of regulation works well, so the proposals focus on how the model needs to be adapted in light of the new status quo post-Brexit (in particular the increased responsibility of the UK regulators in setting regulatory requirements) and how retained EU law should be dealt with to fold it into this model. HM Treasury is proposing new powers under which the government would be able to repeal retained EU legislation that the regulators would replace with appropriate regulatory requirements in their own rulebooks. HM Treasury notes that this transition would need to take place over several years, and it expects the regulators to replace the repealed provisions with similar rules initially, indicating that this would not necessarily be the main juncture for the review of retained EU legislation.

While this may be the case, it is also likely that a key driving force behind this proposal is the intention to diverge significantly away from the EU regime in many areas over time (see section 2, above), as changing rules is easier than amending legislation. Therefore, even though significant progress is not likely during 2022, firms need to be prepared for onshored regimes to be migrated into rules in the medium term. Although firms may question exactly how the regulators are going to resource this significant task, they will also ask themselves how they can prepare for the increased regulatory change workload. Even if the intention is not to change the rules considerably at this initial stage, the proposals will still need to be reviewed

4 Future Regulatory Framework Review

continued

and analysed, and there will be differences and nuances stemming from both intended and unintended divergence. Firms will also need to be mindful of this impending change when considering, for example, how to future-proof legislative references in contractual and client documentation.

Designated Activities Regime

The proposed Designated Activities Regime suggested in the consultation is, however, a truly radical proposal. Under this regime, HM Treasury would be able to designate an unregulated activity (for instance, services relating to alternative assets) and the PRA or FCA would then need to create and apply rules to both regulated and unregulated firms. The Designated Activities Regime is being proposed because at the moment the regulators do not have powers to make rules that apply outside the regulated sector, but certain EU regimes that have been onshored (for example, the short selling regime) apply more broadly. Therefore, the regulators would need wider powers in order to replicate such regimes in their rules.

HM Treasury considers it would be beneficial to have some regimes that do not require authorisation, but that impose certain regulatory requirements on anyone performing the relevant activities. However, the scope of the Designated Activities Regime would not be limited to pre-existing EU regimes and HM Treasury would be able to designate other unregulated activities in the future. This degree of flexibility may tempt legislators and regulators to react to past or emerging problems by designating the relevant activity (for example, buy-now pay-later might have been dealt with under the Designated Activities Regime, were it already in place). Throughout the course of 2022, firms will want to understand how this regime will impact them, and potentially also other unregulated members of their groups.

5 Diversity and Inclusion

Key dates

- Early 2022: Policy Statement due on diversity and inclusion on public company boards and executive committees
- H1 2022: Joint PRA and FCA Consultation Paper expected on diversity and inclusion
- H2 2022: Policy Statement and final rules on diversity and inclusion expected

Diversity and inclusion is not a new area of focus for the regulators, but it is taking on increasing importance and prominence. While the regulators have emphasised the importance of diversity throughout a firm's ranks for some time, particularly at senior level, they have not seen the change they would have liked and feel policy measures are necessary.

Diversity and inclusion ties in with various other regulatory initiatives, most obviously culture and conduct. Nikhil Rathi has discussed adding a sixth question to the five conduct questions: "Is your management team diverse enough to provide adequate challenge and do you create the right environment in which people of all backgrounds can speak up?". What the regulators are really hoping for is widespread cultural change within firms, and ideally this would happen organically rather than through policy requirements, but ultimately the regulators are focusing on the need for progress.

Issues around diversity and inclusion have also come to the fore with the increased importance of ESG considerations (see section 1, above). Consequently, firms may start to feel the pressure to make progress in this area not only from the regulators, but also from customers, investors, and business associates. Further, the regulators have explained that they consider diversity and inclusion important not only in terms of a firm's internal culture and governance, but also in relation to how a firm serves its customers. The theory is that a firm composed of a higher number of individuals from underrepresented groups is more likely to understand the needs of its customers. This would drive better outcomes for consumers, meaning that diversity and inclusion also ties into the FCA's new Consumer Duty (see section 9).

So far, the regulators have only issued a Discussion Paper to set out their initial thinking on the policy measures they might seek to introduce. A key theme for 2022 will be how potential policy proposals develop. Firms should also bear in mind that the regulators still expect to see concrete progress on diversity and inclusion prior to the introduction of any policy measures, and will increasingly raise questions around diversity and inclusion as part of their supervisory engagement with firms. Another important

5 Diversity and Inclusion

continued

consideration for firms will be the growing emphasis on socio-economic considerations, alongside other protected characteristics that have often been the focus to date, such as gender and, to an extent, ethnicity. This will require a much more nuanced approach, as socio-economic characteristics are likely to be far more complex and multifaceted.

The Discussion Paper indicates that the regulators will expect boards to play a key role in facilitating change, with some of the ideas discussed including requiring the board to set the firm's diversity and inclusion strategy and policy and oversee progress, expecting the board to monitor and challenge progress on diversity and inclusion — including holding management to account — and introducing specific targets for board representation. The FCA has also consulted on separate proposals to introduce a requirement for listed companies to disclose in their annual financial report whether they meet specific board diversity targets on a "comply or explain" basis.

Not only will the composition of board and senior management act as a key measure of whether firms are becoming more diverse and inclusive, the regulators are likely to link progress on diversity and inclusion across the firm as a whole to Senior Manager accountability under the SMCR. In particular, the regulators are exploring whether adverse findings in relation to individuals' conduct with respect to diversity and inclusion issues could affect fit and proper assessments. They may also look to develop guidance on how sexual harassment, bullying, and discrimination on the basis of someone's protected characteristics, or failure to take reasonable steps to address this kind of behaviour, could result in a breach of the Conduct Rules. Indeed, the FCA would relish the chance to hold a Senior Manager to account for failing to address cultural issues within their team, or for the non-financial misconduct of someone within their team.

Firms will need to spend 2022 familiarising themselves with the regulators' proposed policy measures and reflecting on what steps they can take to develop a diverse and inclusive culture in the meantime. They also need to consider how they can demonstrate to the regulators that they are making tangible progress and have a credible change programme in place, if required.

6 IFPR

Key dates

- 1 January 2022: IFPR takes effect
- 1 February 2022: Deadline for existing CRR firms holding AT1 capital instruments to notify the FCA of their intended use of those existing capital instruments under MIFIDPRU; deadline for applications by firms wishing to apply the group capital test on a temporary basis
- 2022: Remuneration requirements apply from the start of first performance year from 1 January 2022; first ICARA reference date; first reference date for IFPR disclosures

For many firms, the Investment Firms Prudential Regime (IFPR) will be a dominant theme in 2022. Any regulation that simultaneously addresses capital requirements, governance, and remuneration is likely to attract senior attention. For many IFPR firms, the capital regime will actually be an improvement as it will result in a more tailored and proportionate regime (although there will be some losers), but it will also constitute a significant technical change. One of the most important cliff edges in the UK regulatory regime will now be between the largest investment firms that are caught by "big bank" pay restraint measures, and those that are not. In particular, no IFPR firms will be subject to a specific bonus cap, although firms will be required to ensure a suitable ratio between fixed and variable remuneration.

Firms within scope of the IFPR will have laid the groundwork during 2021 to determine their classification, how the IFPR applies on a group basis if relevant, and how they are going to implement the regime. Certain firms will have a transitional period that runs until 2027 to meet the full capital requirements, so they avoid a dramatic increase in the amount of capital they need to hold. However, 2022 will see firms needing to tackle the mechanics of the new regime, ensuring their calculations are correct and that they are prepared to make the relevant disclosures and notifications at the appropriate time.

Larger IFPR firms (known as non-SNI firms under the regime) had to start collecting data for calculating their K-factor requirements (which feed into own funds requirements) from 1 December 2021 and will need to get used to this new system, which demands a number of technical calculations (depending on how many K-factors apply to the firm's business).

Firms will need to adapt to the new reporting schedule under the IFPR, and the FCA plans to update firms' reporting schedules in mid-January, based on the data provided in their IFPR set-up questionnaire. However, firms will still need to complete existing prudential returns that cover the reporting period up to and including 31 December 2021, even if they are due to be submitted during 2022.

In terms of IFPR disclosures, a firm with a financial year end in 2022 that falls on or before 30 December 2022 will

6 IFPR

continued

make its first required disclosures under the IFPR from that date for own funds, own funds requirements, and governance. The firm will only be required to make its first disclosures for risk management and investment policy starting from its year end falling in 2023 (i.e., following the first full year of IFPR application). However, if a firm has a financial year end of 31 December 2022, it will make all of its required disclosures (including for risk management and investment policy) for the first time following that date, as it will have had a full year under the IFPR.

IFPR firms also need to adjust to the ICARA process, which replaces the ICAAP and consolidates FCA requirements in relation to business model analysis, stress-testing, recovery planning and actions, and wind-down planning. A firm's first ICARA reference date will need to be in 2022, but it need not submit its first ICARA questionnaire until 2023.

The new remuneration rules under the IFPR, which are likely to be a significant step-up for smaller firms that benefitted from a very limited application of the remuneration rules under the previous regime, will apply from the start of a firm's first performance year beginning on or after 1 January 2022. Firms must make their first remuneration disclosures on the same date that they publish their first annual financial statement after the end of the first performance period to which the MIFIDPRU Remuneration Code applies. Most firms with performance periods of 12 months will not need to make their first MIFIDPRU remuneration disclosures until 2023.

7 Operational Resilience

Key dates

- 31 March 2022: New regulatory framework on operational resilience and new PRA Supervisory Statement on outsourcing take effect
- H1 2022: PRA to consult on an online outsourcing register and on operational resilience incident reporting
- 2022: Discussion Paper expected on the oversight of critical third parties

New Operational Resilience Framework

The new operational resilience framework was set out in final rules published by the PRA and the FCA in March 2021. The framework applies to PRA-authorised firms, Recognised Investment Exchanges, FCA firms within scope of the enhanced SMCR, payment services firms, and e-money institutions. By 31 March 2022, these firms will need to have both carried out the necessary mapping and testing to enable them to identify their important business services and set relevant impact tolerances for each of these services, and have actually identified those services and set those tolerances. Also by 31 March, firms will need to have prepared self-assessment documentation, developed internal and external communications plans for when important business services are disrupted, and conducted lessons learnt exercises to be able to respond and recover from disruptions as effectively as possible.

However, a three-year transitional period will mean that firms will not be expected to remain within the impact tolerances they have set or to operate consistently within those impact tolerances before 31 March 2025. Therefore, 31 March 2022 is more of an interim deadline for firms, with additional work to be done after that to meet the regulators' expectations. Further, the regulators have designed the framework on the assumption that disruptions will occur. The overall policy aim is to ensure that firms are sufficiently prepared for such disruptions, can respond effectively, and can restore services efficiently. Firms should note that the regulators do not expect them to be able to prevent all disruptions.

Firms have had to do a significant amount of preparation despite a reasonably long lead-in time. Further, given the pace of regulatory change and other global developments, this area has not necessarily attracted the focus and resource it might otherwise have garnered. The new requirements are much more comprehensive and detailed than previous expectations in this area, reflecting the increased risk of operational incidents and their potential impact on firms, consumers, and the wider financial system. There are also various technical nuances, for example for dual-regulated firms, the PRA's and the FCA's definitions of important business services differ in some respects and firms need to bear in mind the regulators' different objectives when complying with each regime.

The regulators have also designed the regime to be outcomes-based and have avoided imposing overly prescriptive rules. This approach is intended to provide firms with the flexibility to comply with the regime in a way that suits their business. However, it also means that firms have to make various judgement calls regarding how they comply, and that the ultimate regulatory expectations are

7 Operational Resilience

continued

not always clear. Firms should expect regulatory scrutiny of their implementation of the requirements as the framework beds in.

Outsourcing

For dual-regulated firms, the PRA's new Supervisory Statement on outsourcing and third-party risk management will also take effect on 31 March 2022. The Supervisory Statement aims to clarify regulatory expectations in this area and bring them up to date with current market and technological developments. Outsourcing arrangements entered into on or after 31 March 2021 should meet the expectations set out in the Supervisory Statement by 31 March 2022, so firms will need to ensure that both new and recently implemented arrangements comply. Legacy outsourcing agreements entered into before 31 March 2021 will need to be revised to meet the new expectations at the first appropriate contractual renewal or revision point, as soon as possible on or after Thursday 31 March 2022. Therefore, throughout 2022, dual-regulated firms will need to focus on ensuring that legacy contracts have been updated.

Further work is also envisaged in relation to outsourcing, with the PRA planning to consult during 2022 on setting up an online outsourcing register that dual-regulated firms would need to populate with information on their outsourcing and third-party arrangements. The Bank of England, PRA, and FCA also plan to publish a joint Discussion Paper in 2022, to inform potential future regulatory proposals in relation to critical third-party service providers in light of firms' increasing reliance on such entities.

Hybrid Working

Another important focus area for firms is how they can ensure a sufficient level of operational resilience in the context of hybrid working models. The FCA has emphasised that, since a significant amount of home working is likely to continue for the foreseeable future, firms need to be conscious of issues such as the increasing use of third-party providers, the security of virtual private networks and of personal devices, information security, and protecting confidential information. The FCA has also warned that as many firms delayed non-essential system upgrades and change programmes during the height of the pandemic, they now face managing multiple upgrades simultaneously and need to take care that this task does not cause undue disruption.

8 Financial Promotions Regime

Key dates

- Early 2022: FCA expected to consult on rules for high-risk investments and for firms approving financial promotions
- 9 March 2022: HM Treasury consultation on changes to the financial promotion exemptions for high net worth individuals and sophisticated investors closes for comment

The financial promotions regime has been an unusually stable part of the regulatory landscape. 2022 is likely to change that as the FCA and HM Treasury consult on various areas of reform.

The FCA has become particularly concerned about the products being promoted to less sophisticated investors, and launched a discussion in 2021 about how it could potentially strengthen the financial promotion rules for high-risk investments. Additional restrictions do currently apply to the promotion of certain investments seen as higher risk (such as non-mainstream pooled investments), but these have tended to come about on an ad hoc basis in response to specific concerns, rather than as part of a consistent policy approach. The FCA is now considering how it can further segment the high-risk investment market, and what should be classified as high-risk for these purposes. The FCA intends to consult on specific proposals early this year. HM Treasury has also consulted separately on whether to bring (unregulated) cryptoassets within scope of the financial promotion regime and we expect to see the outcome of this consultation during 2022. Firms involved in the promotion of non-standard products to retail clients who have previously utilised financial promotion exemptions will need to navigate these proposals, and the potential restrictions that may come out of them.

The FCA is also concerned about the rise of online scams and consumers being targeted by fraudulent advertisements for financial products, and has been lobbying for the Online Safety Bill to address this. We will see in 2022 whether the Bill will include such paid-for online advertising within its scope.

Throughout 2021 the FCA hinted several times about its concerns over the exemptions from the financial promotion regime for high net worth individuals and sophisticated investors. The financial thresholds, which have not been revised since they were introduced in 2001, clearly have been long outdated. The FCA and the government are also concerned that the exemptions are being misused in some instances to market investments to individuals who do not meet the criteria for the exemptions.

As amending these exemptions would require legislative change, HM Treasury is consulting on potential modifications. HM Treasury considers that these exemptions should be retained, but is consulting on five proposals for change that include increasing the financial thresholds for high net worth individuals, placing a greater degree of responsibility on firms to ensure individuals meet the criteria to be deemed high net worth or sophisticated, and updating the high net worth individual and self-certified sophisticated investor statements to prompt more

8 Financial Promotions Regime

continued

engagement from individuals when signing the statements. The proposals are not revolutionary, but will add greater friction to the process of using these exemptions. Firms that frequently rely on these exemptions will need to think about the potential impact these changes could have. HM Treasury has not yet mapped out when the changes might apply, but they could feasibly be in place by the end of 2022.

Finally, firms will, for the first time, be required to hold the right regulatory permissions if they want to approve financial promotions for third parties (the so-called regulatory gateway). Currently, any authorised firm can approve any financial promotion on behalf of an unauthorised firm. HM Treasury announced in June 2021 that it would be introducing a regulatory gateway to restrict the approval of financial promotions on behalf of unauthorised firms by imposing a specific financial promotion requirement on all new and existing authorised persons. An existing authorised firm wishing to approve financial promotions would then need to apply to the FCA for a variation or cancellation of this requirement. A firm applying for authorisation would be able to specify whether it would like to have the financial promotion requirement varied or cancelled as part of the application process. HM Treasury now needs to bring forward the legislation to implement this gateway.

The FCA also needs to consult on its proposals for implementing the gateway and the mechanics around it. These points will likely be included in the FCA consultation due early this year. Although clear timings for implementing the gateway have not been proposed at this stage, HM Treasury envisages a three-phase transitional period to allow firms to adjust to the change. The new regime likely will not start to apply during 2022 given the plans for staged implementation, but firms should consider during 2022 whether they wish to retain the ability to approve financial promotions for unauthorised firms.

9 Consumer Duty

Key dates

- 15 February 2022: FCA CP21/36 closes for comment
- By end July 2022: Policy Statement to CP21/36 and final rules expected
- 30 April 2023: Date by which FCA proposes firms should have fully implemented the Consumer Duty

The FCA is currently consulting on introducing a new Consumer Duty in relation to retail clients. The regulator has emphasised that it expects to see a cultural shift from firms, positioning consumers at the heart of what they do and focusing more on ensuring good consumer outcomes (rather than just following the rules in a tick-box manner). Regardless of how firms might view the proposals, the FCA sees the introduction of a Consumer Duty as a seminal change and expects firms to implement it with this in mind.

As currently proposed, the new Duty will include a package of measures based around a Consumer Principle that requires firms to act to deliver good outcomes for retail customers. Firms will be concerned to understand how they can meet this highly subjective standard, and what happens when the firm has taken the right action but customers still have not necessarily received a good outcome. The regime effectively will introduce product governance measures in areas where such requirements have not applied before. A key challenge for firms will be working out exactly what is already covered by existing rules, where they are already meeting expectations, and where there are gaps that they will need to fill. Another challenge for firms will be working out which customers are in scope, given that the FCA is proposing to delineate the scope by reference to the definition of a retail client in each sectoral sourcebook. So the scope will depend on the particular business line and firms will potentially need to navigate applying the Duty to different populations of customers.

Doubtless, given the cultural and behavioural change the FCA is hoping to initiate, it will look to enforce its new rules and guidance stringently once they apply, and will also look to hold Senior Managers to account if firms are not meeting expectations. Indeed, the proposals state that the FCA will expect there to be an annual report to the board assessing whether the firm is acting to deliver good outcomes for its customers that are consistent with the Consumer Duty, and boards will be expected to play a key role in driving the cultural change the FCA wants to see. Therefore, boards and senior management will need to ensure they are leading the change and will be conscious that they could be held accountable for their firm's failure to implement the Duty effectively. The proposed new Conduct Rule to mirror the Consumer Principle will also establish individual responsibility for achieving good outcomes for customers, and firms will need to provide appropriate training to their Conduct Rules staff on what this means for them.

The FCA is not proposing to attach a private right of action to any part of the Consumer Duty at this stage, so while the Duty may open up new avenues of exposure for firms, Senior Managers and Conduct Rules staff, it will not introduce the possibility of a potential sea of claims from

9 Consumer Duty

continued

consumers relying on the Consumer Duty itself. Of course, consumers are likely to argue that the existence of the Consumer Duty informs how their common law rights (and whether a tortious duty of care is owed) should be interpreted.

Although, on the current timescale, firms will not need to have implemented the Consumer Duty in 2022, it is going to be a crucial year of preparation, particularly once the rules have been finalised in the summer. In practice, the FCA has already been considering how firms are achieving good consumer outcomes as part of its supervisory activities, and in some senses it is already behaving as if the Duty were in place. The FCA has emphasised that it will expect firms to use the implementation period fully, and that it will monitor firms' implementation during this period. Consequently, firms need to be planning now for how they will run their implementation project, and how this will demonstrate to the FCA that they are taking the changes sufficiently seriously. Notably, the cost benefit analysis in the consultation states that the FCA expects implementation costs to be "large", and firms should consider this an indication of how the FCA expects them to coordinate their implementation projects.

While the Consumer Duty will not apply with retrospective effect, it will apply, on a forward-looking basis, to all products still being sold or renewed, and to closed products that are still in place. Therefore, firms will need to carry out a thorough review of existing products and services as part of their implementation work. This is likely to demand a significant amount of time and resource and firms will need to start planning now for how they will achieve this.

Inevitably, a key factor in the impact and success of the Consumer Duty will be how it is supervised and enforced in practice. Although this will not become clear until after the Duty is in place, the FCA's rhetoric around the new Duty has clarified that the regulator expects to embed considerations around consumer outcomes across its supervisory work. Firms must also remember the origins of this change — lobbying from consumer groups and a statutory requirement to consult on whether to introduce a duty of care (watered down at the last minute from a requirement to introduce a duty of care) in light of recent financial scandals. Consequently, the FCA will be under significant political pressure to take action when it sees actual or potential harm. The FCA proposes to use its more assertive regulatory approach (see section 3, above) to supervise and enforce the Consumer Duty, although it envisages that if the changes have the intended effect more of its intervention work will be pre-emptive rather than responding to harms that have materialised.

10 AML / Financial Crime

Key dates

- Spring 2022: Feedback due from HM Treasury's consultation on amendments to the Money Laundering Regulations, and amending legislation to be made
- H1 2022: Feedback due from HM Treasury's Call for Evidence on the UK's AML/CFT regulatory and supervisory regime

Enforcement

The FCA has always had a strong focus on preventing financial crime, but since Mark Steward's arrival as Director of Enforcement there has been an even firmer emphasis on this area. Mr Steward mentioned in 2019 that the FCA would routinely open "dual-track" investigations into suspected breaches of the Money Laundering Regulations, meaning that it will open an investigation on the basis that it might choose to pursue criminal or civil proceedings, according to how the case unfolds. This had already been common practice for the FCA with market abuse investigations, and the FCA has had the power to pursue criminal cases for money laundering failings by firms since the Money Laundering Regulations 2007 came into force.

However, it has taken until now for the FCA to achieve a successful criminal prosecution under the Money Laundering Regulations. While the facts of that case are quite extreme, and any criminal prosecution for money laundering failings is likely to be exceptional, firms need to be conscious that the criminal prosecution route is an option for the FCA, and that the FCA is unafraid to deploy the resources needed to pursue such cases. The FCA will have been bolstered by its success in this case, and by other recent high-profile regulatory fines it has imposed for money laundering failings. Indeed, some of the FCA's largest fines over the last few years have related to financial crime.

A recent FCA response to a Freedom of Information Act request revealed that the FCA is considering whether or not to pursue criminal proceedings in seven other cases, and that overall the number of open investigations for money laundering failings (both criminal and civil) has almost doubled in the last year. While many firms do have adequate financial crime systems and controls in place, these are often not appropriately deployed in practice, fail to operate as intended, or are degraded over time through cost cutting and under-investment. Now may be a good juncture to review these systems and controls if firms have not done so recently. Mr Steward has warned firms that systems and controls risk becoming a "bureaucratic insulation", and that "systems can become overly complicated, bureaucratised, vulnerable to gaming by less scrupulous players".

Firms need to ensure that, when reviewing financial crime systems and controls, they think about their overarching purpose and consider whether they are achieving that purpose. While controls may look effective on paper, firms need to make sure that red flags are raised at the appropriate time and are dealt with by the appropriate people. They also need to ensure that they look at concerns holistically and deal with them consistently, and that they review and re-evaluate client relationships when concerns are raised. A key lesson from recent cases is that just because a higher-risk client has been onboarded

10 AML / Financial Crime

continued

and has passed the initial checks, a firm cannot thereafter always assume there is no need to reassess the risk that client presents. Given the focus on financial crime, firms can expect to see more FCA action over the coming year. While that has been a somewhat constant refrain of the FCA over the past several years, recent decisions are finally bringing that threat home to roost.

Reporting

The FCA also recently published its analysis of firms' annual financial crime data returns for the first three reporting periods since the return was introduced (2017-2020). Interestingly, the FCA reports that the number of Suspicious Activity Reports (SARs) reported to the National Crime Agency (NCA) has increased from 394,048 in 2017/2018 to 480,202 in 2019/2020. The number of SARs reported internally to MLROs has also increased. In the latest reporting year, close to half of the 1,028,260 SARs reported internally to MLROs were from three firms, and the same firms were also responsible for more than 60% of the SARs reported to the NCA. The FCA observes that the difference between the volume of SARs reported to the NCA and the volume of SARs reported internally to MLROs also varies greatly between firms. This variation suggests that some firms may have very different risk appetites and therefore firms should review their reporting thresholds in 2022 to ensure that they are appropriate.

Whilst "defensive" reporting is a known problem in this context because of the breadth of the UK anti-money laundering regime, those firms that are passing on a significantly lower proportion of internal SARs to the NCA than others may expect to be subject to closer scrutiny to ensure that useful information is not falling between the cracks.

Upcoming Changes

As with most areas of UK regulation, the anti-money laundering and counter-terrorist financing regulatory and supervisory regimes are currently under review. HM Treasury published a Call for Evidence on a review of the UK's anti-money laundering and counter-terrorist financing regulatory and supervisory regime, and a Consultation Paper on amendments to the Money Laundering Regulations 2017, in July 2021. The outcomes of both of these are due to be published in 2022. The proposed amendments to the Money Laundering Regulations 2017 are relatively minor in nature and aim to ensure that the UK continues to meet international standards and clarify ambiguities following Brexit. The Call for Evidence is a more comprehensive review and requested feedback on three key areas: the overall effectiveness of the Money Laundering Regulations 2017, whether they are operating as intended, and the effectiveness and appropriateness of the structure of the supervisory regime. In 2022, firms will need to follow the outcomes and look out for further policy proposals in light of the Call for Evidence.

Contacts

Trivali Anand
Associate
T +44.20.7710.1074
E trivali.anand@lw.com

David Berman
Partner
T +44.20.7710.3080
E david.berman@lw.com

Charlotte Collins
Knowledge Management Lawyer
T +44.20.7710.1804
E charlotte.collins@lw.com

Alex Cox
Associate
T +44.20.7710.1873
E alex.cox@lw.com

Becky Critchley
Associate
T +44.20.7710.4519
E becky.critchley@lw.com

Paul Davies
Partner
T +44.20.7710.4664
E paul.davies@lw.com

Nicola Higgs
Partner
T +44.20.7710.1154
E nicola.higgs@lw.com

Jon Holland
Partner
T +44.20.7710.4766
E jon.holland@lw.com

Sid Lal
Associate
T +44.20.7710.4778
E sidhartha.lal@lw.com

Anne Mainwaring
Associate
T +44.20.7710.1018
E anne.mainwaring@lw.com

Catherine McBride
Partner
T +44.20.7710.3081
E catherine.mcbride@lw.com

Ella McGinn
Associate
T +44.20.7710.4649
E ella.mcginn@lw.com

Andrea Monks
Partner
T +44.20.7710.4767
E andrea.monks@lw.com

Rob Moulton
Partner
T +44.20.7710.4523
E rob.moulton@lw.com

Jaime O'Connell
Associate
T +44.20.7866.2655
E jaime.oconnell@lw.com

Denisa Odendaal
Associate
T +44.20.7710.1845
E denisa.odendaal@lw.com

Nell Perks
Associate
T +44.20.7710.4749
E helennell.perks@lw.com

Jonathan Ritson-Candler
Associate
T +44.20.7710.1815
E jonathan.ritson-candler@lw.com

Sean Wells
Associate
T+44.20.7710.4662
E sean.wells@lw.com