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PRIVATE BANK BRIEFING

LATHAM & WATKINS

Issues Impacting the Private Bank Sector

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

In This Edition

MiFID: ESMA Q&A on Enhancing the Quality of the Service to the Client

On 31 March 2021, ESMA updated its Questions and Answers on investor protection topics under MiFID II. ESMA has added one new Q&A clarifying when an inducement can be considered as designed to enhance the quality of the relevant service to the client.

While the new Q&A does not apply in the UK post-Brexit, it does provide helpful additional context for private banks on interpreting the inducements rule.

The new Q&A provides guidance on the condition in Article 11(2)(a) of the MiFID II Delegated Directive that an inducement is justified by the provision of:

1. An additional or higher-level service
2. Addressed to the relevant client
3. Proportional to the level of inducements received

ESMA emphasises that firms ultimately will need to make a case-by-case assessment as to whether or not an inducement is justified, but they should take account of the guidance provided in order to ensure a consistent application of the requirements.

Additional or higher-level service

ESMA states that the reference to "additional or higher level" requires that the quality enhancement provided should go beyond aspects of the firm's organisation or services that are legally required or that can be considered as essential for its functioning.

Examples of services that should be considered as "additional or higher level" include the provision of educational materials or services aimed at increasing the financial knowledge of the client, such as free access to training or providing free access to market data, investment research, or the free provision of digital tools and apps aimed at helping clients to monitor their investments.

Examples of services that should not be considered as "additional or higher level" include providing regulatory documents such as a prospectus or a KID, or disclosure documents such as costs and charges disclosures, as these are required by law.

Addressed to the relevant client

ESMA underlines that the provision of quality-enhancing services to the relevant client means that the services should be actively and effectively offered and brought to the attention of the relevant client. An abstract offer of the quality-enhancing service made to all clients and not adequately communicated to the specific client will not be sufficient to comply with this requirement. However, ESMA does clarify that the quality enhancement can be provided to a relevant segment of clients, provided that this segment is sufficiently homogeneous.

Proportional to the level of inducements received

ESMA underlines that it is the level of inducements received by the firm that is of relevance, not the client's investment amount. ESMA states that it expects firms to be able to demonstrate that the quality enhancements provided to the client are proportional to the level of inducements received by the firm.

MiFID: FCA Consultation Paper on Changes to UK MiFID's Conduct and Organisational Requirements

On 28 April 2021, the FCA published a Consultation Paper (CP21/9) on changes to UK MiFID's conduct and organisational requirements.

The proposed changes relate to research unbundling and best execution — two areas covered by the EU "quick fix" amendments to MiFID II. However, the FCA's proposals differ from the changes made in the EU, with the FCA noting that they reflect the different circumstances in the UK and the FCA's own analysis as to how best to improve the regime.

The FCA proposes to create several new exclusions from the inducements rule for certain types of research by adding to the list of acceptable minor non-monetary benefits. The exclusions would cover:

- Research relating to an SME with a market capitalisation below £200 million. The EU equivalent sets this threshold at €1 billion.
- Research received in connection with an investment strategy primarily relating to fixed income, currencies, and commodities instruments.
- Research provided by independent research providers, where the independent research provider is not engaged in execution services and is not part of a financial services group that includes an investment firm that offers execution or brokerage services.
- Written material that is made openly available from a third party to any firms wishing to receive it or to the general public. The FCA proposes that, in this context, "openly available" would mean accessible without conditions or barriers such as a log-in, sign-up, or submission of user information.

The FCA also proposes to remove the requirements to produce RTS 27 and RTS 28 reports. This differs from the EU approach, where the obligation to produce RTS 27 reports has been temporarily suspended while the European Commission assesses whether to revise the requirements or delete them permanently.

The consultation closed on 23 June 2021, and the FCA expects to publish a Policy Statement in the second half of 2021. While the proposed changes in the UK are helpful, they also provide a sense for the industry as to how EU and UK MiFID may diverge over time. The UK certainly has not taken the approach of simply copying out the EU quick-fix changes, but instead has considered what changes are appropriate for the UK market.

Further reform of MiFID II is anticipated at both the EU and UK levels. In the UK, a planned HM Treasury consultation this summer will look more broadly at capital markets reform. The FCA expects to publish at least two other related consultation papers this year on the consequences of LIBOR transition for the derivatives trading obligation and changes to markets requirements. The wider EU review of MiFID II remains ongoing, and the Commission is expected to publish a legislative proposal by the end of the year. Private banks will need to follow these developments closely to keep abreast of proposed changes and how divergence between UK and EU MiFID might impact pan-EU business.

For more detail, please see Latham's related blog post.

Operational Resilience and Outsourcing: Regulators Publish Final Policy Frameworks

On 29 March 2021, the PRA, FCA, and Bank of England published their final Policy Statements and shared policy summary on building operational resilience in the financial services sector. The PRA's Policy Statement is complemented by guidance in a new Supervisory Statement (SS1/21), "Operational Resilience: Impact tolerances for important business services". The PRA also published its related Policy Statement (PS7/21) on outsourcing and third party risk management. The regulators originally consulted on these proposals in December 2019, with a view to implementing a stronger regulatory framework to promote the operational resilience of firms.

Operational resilience

The new rules on operational resilience set requirements and expectations on firms to:

- Identify their important business services by considering how disruption to those services can have impacts beyond their own commercial interests, including, where relevant, harm to consumers, harm to market integrity, and threats to safety and soundness and financial stability
- Set a tolerance level for disruption for each important business service at the first point at which a disruption would pose an intolerable risk in various respects (e.g., harm to consumers or the firm's safety and soundness)
- Carry out mapping exercises and scenario testing to ensure they can continue to deliver their important business services and are able to remain within their impact tolerances during severe but plausible scenarios

Firms will necessarily need to take different approaches based on their business, and the regulators wish to encourage senior managers to make appropriate judgments.

The aim of the new requirements is to ensure that firms are prepared for scenarios in which they are unable to operate as usual and cannot provide their services for a period of time. The regulators note that many respondents requested additional detail on how they might apply the proposals. The regulators have provided additional explanations and examples, where relevant, but emphasise that they do not want to be too prescriptive. Firms will necessarily need to take different approaches based on their business, and the regulators wish to encourage senior managers to make appropriate judgments.

A related speech by Lyndon Nelson of the PRA highlights that the framework is principles- and outcomes-based. Mr Nelson notes that many firms have requested further guidance or more ways of receiving assurance that they are meeting regulatory expectations. However, the regulators do not want to offer a rigid and prescriptive approach, as they believe this will do nothing to help firms avoid the harm they are seeking to prevent. The regulators want firms to demonstrate that they understand their risks and spend their energy and resources addressing them.

The regulators note that, although their policy frameworks are designed with their own objectives and legal frameworks in mind, they view the design and goals of their respective policies as the same. As such, the regulators plan to supervise the new requirements on this basis and do not intend for dual-regulated firms to have to undertake duplicative work to satisfy the requirements of both regulators.

Outsourcing

The PRA's new Supervisory Statement (SS2/21) on outsourcing sets out how the regulator expects firms to comply with the wide range of existing requirements on outsourcing throughout the lifecycle of an arrangement. These range from the application of proportionality, to outsourcing agreements, audits, and exit plans. The PRA emphasises that the guidance in the Supervisory Statement should be read alongside the underlying legal obligations. SS2/21 also aims to implement the guidance in the EBA Guidelines on outsourcing, which the PRA has onshored.

The PRA notes that it is planning to publish a follow-up consultation setting out detailed proposals for an online portal on which all firms would need to submit information on their outsourcing and third party arrangements. The PRA also plans to further analyse whether additional policy measures to manage the risks that critical third parties could pose to firms' objectives might be appropriate. Subject to the outcome of this analysis, the PRA may engage with industry and other relevant external stakeholders in due course.

Timing

The new frameworks will come into force on 31 March 2022. The PRA states that firms should contact their supervisors to agree their plans for meeting the policy requirements. By 31 March 2022, firms must have identified their important business services, set impact tolerances for the maximum tolerable disruption, and carried out mapping and testing to a certain level of sophistication necessary to do so. Firms must also have identified any vulnerabilities in their operational resilience and implemented a strategy or plan that sets out how they will comply with the regulators' requirements. However, firms are not expected to have performed mapping and scenario testing to the full extent of sophistication by this time. Rather, as soon as possible after 31 March 2022, and no later than 31 March 2025, firms must have performed sufficient mapping and testing to remain within impact tolerances for each important business service. Firms must also have made the necessary investments to enable them to operate consistently within their impact tolerances.

Firms will need to meet the same 31 March 2022 deadline for implementing the outsourcing requirements in relation to outsourcing arrangements entered into on or after 31 March 2021. For outsourcing arrangements entered into prior to 31 March 2021, firms are expected to review and update these arrangements at the first appropriate contractual renewal or revision point to meet the expectations as soon as possible on or after 31 March 2022. The PRA considers that it is no longer proportionate for firms to make every effort to comply with the indicative timeline and process for reviewing their material legacy outsourcing arrangements as set out in the EBA Guidelines (which require firms to have reviewed and amended legacy arrangements by 31 December 2021).

Private banks will need to consider how they plan to implement the new requirements and meet regulatory expectations. It is clear that the regulators expect a much more robust approach to operational resilience than has previously been the case. Therefore, private banks should consider the full spectrum of potential business disruptions and focus on how they would continue to service their customers to an acceptable level in such situations. This is a key regulatory focus area, so private banks should expect their implementation plans to be closely scrutinised by the regulators.

LIBOR: Joint Dear CEO Letter on Priority Areas for LIBOR Transition

The FCA and the PRA jointly published a Dear CEO letter on the transition from LIBOR to risk-free rates (RFRs) on 26 March 2021. This followed the FCA's statement on 5 March 2021 announcing the cessation dates for all panel bank LIBOR settings. These moves come as the regulators begin to step up their supervisory focus on LIBOR transition as its cessation draws near. Therefore, private banks should ensure that they have implemented robust plans for their transition away from LIBOR and are prepared to meet all relevant deadlines.

In the letter, the regulators set out a non-exhaustive list of priority areas where further action by firms is necessary to prepare for the cessation of LIBOR. Private banks should take particular note of these areas, which include:

- **Systems readiness for LIBOR cessation:** The regulators expect firms to prioritise resources that will expedite the delivery of strategic front-to-back technology solutions for RFRs. Any short-term tactical solutions should be "robust", not place undue constraints on RFR volumes, and be subject to appropriate controls. The operational resilience implications of reliance on tactical solutions should be "controlled and managed within an explicit and defined firm risk appetite".
- **Active transition of legacy LIBOR exposures:** The regulators expect firms to have amended all legacy sterling LIBOR contracts by the end of Q3 2021, where possible, at least to include a contractually robust fallback that takes effect upon an appropriate event, or, preferably, an agreed conversion to a robust alternative reference rate. Such action should leave behind "only those contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended".
- **Conduct risk mitigation:** Firms are expected to identify and address risks, and keep their customers appropriately informed about the impact of LIBOR cessation on their financial products and services.
- **Development of RFR markets:** Firms should intensify their efforts to transact using RFRs, and clearly explain the efforts they are undertaking to facilitate the transition of products from LIBOR.
- **Selection of appropriate alternatives to LIBOR:** As an overarching consideration, firms should ensure that the selected replacement rate meets customers' needs and that customers understand the properties and implications of the rates they are moving to. Firms should also take into account relevant industry guidelines and recommendations regarding alternative rates.

ESG: Sustainable Finance Amendments to EU Sectoral Legislation

On 21 April 2021, the European Commission published six amending Delegated Acts as part of its sustainable finance package in order to embed sustainability considerations within the following sectoral legislation:

- MiFID II
- AIFMD
- UCITS
- Solvency II
- Insurance Distribution Directive

These amendments are designed to reinforce the Sustainable Finance Disclosure Regulation, the Taxonomy Regulation, and the Low Carbon Benchmarks Regulation by integrating sustainability considerations into the investment, advisory, and disclosure processes in a consistent manner across sectors.

Amendments to MiFID II

The amendments to MiFID II are set out across two amending Delegated Acts and will make the following key changes:

- **Organisational requirements and risk management:** Firms will be required to take into account sustainability risks when complying with the MiFID II organisational requirements, including: (i) in their risk management policies; (ii) in their procedures to identify the risks relating to the firm's activities, processes, and systems; and (iii) when setting the level of risk tolerated by the firm.
- **Conflicts of interest:** When identifying conflicts of interest that may damage the interests of a client, firms will be required to include conflicts of interest that stem from the integration of the client's sustainability preferences. For existing clients, if a suitability assessment has already been undertaken, firms may identify the client's individual sustainability preferences at the next regular update of the existing suitability assessment.
- **Information about investment advice:** Firms providing investment advice will be required, when disclosing the factors taken into consideration in the selection process, to include any sustainability factors taken into consideration.
- **Suitability:** Firms providing financial advice or portfolio management services will be required to carry out a mandatory assessment of sustainability preferences of their clients and take these preferences into account (to the extent that a client has sustainability preferences) in the selection process of the financial products offered to these clients. In addition, suitability reports will be required to explain how the recommendation meets the client's sustainability preferences.
- **Product governance:** Firms will be required to embed sustainability considerations into the product governance process. In particular, the target market must specify the type(s) of client with whose needs, characteristics, and objectives (including any sustainability-related objectives) the financial instrument is compatible. The sustainability factors will need to be presented in a transparent manner and provide distributors with the relevant information at a sufficiently granular level to duly consider any sustainability-related objectives of the client or potential client. A negative target market will not be required if the financial instruments consider sustainability factors, in order to avoid limiting the distribution of sustainable products.

The amending Delegated Acts will now need to complete the legislative process, and it is expected that they will apply from October 2022. There are no plans at present to incorporate equivalent changes into the UK onshored versions of these regimes, and so private banks will need to keep an eye on this potential area of regulatory divergence.

ESG: FCA Consults on New Climate-Related Disclosure Requirements

On 22 June 2021, the FCA published two Consultation Papers on introducing new climate-related disclosure requirements, reflecting the FCA's continuing agenda to develop its ESG-related measures, and the UK government's wider ambitions to achieve mandatory climate-related disclosures by 2025.

Asset managers, life insurers, and pension providers

The first Consultation Paper (CP21/17) proposes to introduce mandatory climate-related disclosures for asset managers, life insurers, and FCA-regulated pension providers. The FCA is proposing a disclosure framework consistent with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations. This would consist of both entity-level and product-level disclosures:

Entity-level disclosures

Firms would be required to publish, annually, an entity-level TCFD report on how they take climate-related risks and opportunities into account in managing or administering investments on behalf of clients and consumers. These disclosures would have to appear in a prominent place on the main website for the firm's business, and would cover the entity-level approach to all assets managed by the UK firm.

Product- or portfolio-level disclosures

Firms would be required to produce, annually, a baseline set of consistent, comparable disclosures in respect of their products and portfolios, including a core set of metrics. Depending on the type of firm and/or product or portfolio, these disclosures would either be:

- Published in a TCFD product report in a prominent place on the main website for the firm's business, while also being included, or cross-referenced and hyperlinked, in an appropriate client communication
- Made upon request to certain eligible institutional clients

The requirements would apply to investment portfolio managers, UK UCITS management companies, full-scope UK AIFMs, and small authorised UK AIFMs. Funds in scope would include all authorised funds (excluding feeder funds and sub-funds in the process of winding up or termination), unauthorised AIFs, and portfolio management services.

The FCA intends to introduce the requirements in a new ESG Sourcebook in the FCA Handbook.

The requirements would also apply to life insurers (in relation to insurance-based investment products and defined contribution pension products) and non-insurer FCA-regulated pension providers, including platform firms and Self-invested Personal Pension (SIPP) operators, to the extent that SIPP operators provide a ready-made selection of investments.

The FCA intends to introduce the requirements in a new ESG Sourcebook in the FCA Handbook. The FCA anticipates that this Sourcebook will expand over time to include new rules and guidance on other climate-related topics and wider ESG considerations.

Standard listed companies

The second Consultation Paper (CP21/18) proposes to extend the climate-related disclosure requirements in LR 9.8.6R(8) for premium-listed commercial companies to certain issuers of standard listed equity shares.

The proposals apply to issuers of standard listed equity shares, excluding standard listed investment entities and shell companies. The FCA estimates that this expansion will bring a further 148 companies into scope. The FCA is also seeking views on whether and how it might extend the requirements to issuers of standard listed shares other than equity shares, issuers of standard listed debt (and debt-like) securities, and issuers of standard listed global depositary receipts.

The FCA is looking to introduce a new LR 14.3.27R, mirroring the existing rule for premium listed companies in LR 9.8.6R(8). The proposed rule would require affected companies to include a statement in their annual financial report setting out:

- Whether they have made disclosures consistent with the TCFD's recommendations and recommended disclosures in their annual financial report
- Where they have not made disclosures consistent with some or all of the TCFD's recommendations and/or recommended disclosures, an explanation of why, and a description of any steps they are taking or plan to take to be able to make consistent disclosures in the future and the timeframe within which they expect to be able to make those disclosures
- Where they have included some, or all, of their disclosures against the TCFD's recommendations and/or recommended disclosures in a document other than their annual financial report, an explanation of why
- Where in their annual financial report (or other relevant document) the various disclosures can be found

The FCA is looking to introduce a new LR 14.3.27R, mirroring the existing rule for premium listed companies.

Next steps

Comments on both Consultation Papers are requested by 10 September 2021. The FCA plans to publish Policy Statements with the final rules later in the year.

The disclosure rule for standard listed companies would take effect for accounting periods beginning on or after 1 January 2022. The disclosure rule for asset managers, life insurers, and pension providers would take effect from 1 January 2022 for the largest firms, with an initial publication deadline of 30 June 2023, and from 1 January 2023 for other firms in scope of the proposals, with an initial publication deadline of 30 June 2024.

The FCA is also seeking feedback on certain ESG-related topics in capital markets, and plans to publish a Feedback Statement on this separately in the first half of 2022. The FCA's discussion in CP21/18 focuses on issues relating to green, social, or sustainable-labelled debt instruments and ESG data and rating providers. The FCA also asks respondents to comment on what other ESG topics it should be prioritising.

Financial Promotions: FCA Discussion Paper on Strengthening the Rules for High-Risk Investments

On 29 April 2021, the FCA published a Discussion Paper (DP21/1) on strengthening its financial promotion rules for high-risk investments. The FCA is concerned that, for high-risk investments, a compliant financial promotion may not be enough to ensure that consumers are adequately protected, and so it may need to apply further protections. The FCA considers any investment that is subject to marketing restrictions under its rules to be a high risk investment. This includes non readily realisable securities, peer to peer agreements, non mainstream pooled investments, and speculative illiquid securities. However, the FCA highlights that some of the issues discussed in the paper are relevant to a wider range of investments.

The FCA has identified three main areas in which it could strengthen its rules:

- **Classification of high-risk investments:** The FCA is asking whether there are any investments not currently subject to marketing restrictions that should be, and whether the classification of certain types of investments should be changed to amend the level of marketing restrictions applicable to them. The FCA is conscious that its application of restrictions has developed over time in response to specific harms, and so may not capture all high-risk investments and may leave inconsistencies in how some investments are treated. For example, the FCA is considering including equity shares in the definition of speculative illiquid securities, where equity shares are issued for on-lending, buying, or acquiring investments, or buying or funding the development of property.
- **Further segmenting the high-risk investments market:** The FCA plans to strengthen its rules to further segment high-risk investments from the mainstream market, and is seeking views on certain aspects of this. For example, the FCA seeks views on what can be done to strengthen the investor categorisation process, improve risk warnings, and add "positive friction" to the customer journey in a way that could help lead to more effective decisions. The FCA notes that it wants its interventions to be effective in influencing consumer behaviour, without unnecessarily deterring consumers from making investments that are appropriate. In relation to investor categorisation, the FCA states that it does not believe that maintaining the status quo (which relies largely on self certification) is the right outcome, but equally it wants to ensure that it achieves the right balance between obligations on firms and the regulatory principle that consumers should take responsibility for their own decisions.

The FCA plans to consult on proposed rule changes later this year. The FCA also plans to publish a full response to its Call for Input on consumer investments, together with the next steps of its wider consumer investment strategy, later this year. Private banks should consider the range of investments they market to clients and whether any investments could be targeted with tighter restrictions in future.

Financial Promotions: HM Treasury to Introduce Regulatory Framework for Financial Promotion Approvals

On 22 June 2021, HM Treasury published the response to its consultation on the regulatory framework for the approval of financial promotions.

HM Treasury consulted in July 2020 on whether a regulatory gateway should be introduced for firms to approve the financial promotions of unauthorised firms (currently all authorised firms may approve financial promotions for unauthorised persons). HM Treasury proposed two options in its consultation:

- **Option 1:** Restrict approval of the financial promotions of unauthorised firms through the imposition of requirements by the FCA
- **Option 2:** Specify the approval of financial promotions communicated by unauthorised persons as a regulated activity under FSMA

HM Treasury reports that a considerable majority of respondents supported the introduction of a regulatory gateway, with a slight preference for option 1. Therefore, it has agreed that a gateway should be introduced, through option 1. HM Treasury considers that this approach will achieve the desired objective of strengthening the FCA's supervision of firms approving the promotions of unauthorised persons, whilst maintaining the existing distinction between regulated activities and financial promotions as set out in FSMA.

HM Treasury proposes that all new and existing authorised firms will be prohibited from approving the financial promotions of unauthorised persons through the imposition of a requirement on their permission. Firms that wish to be able to approve financial promotions would need to apply to the FCA to have the prohibition removed, via a variation of requirement. Firms could apply to have the requirement removed entirely, or in part, depending on whether they wish to be able to approve all types of financial promotion or only certain types. An exemption would be available for firms approving the financial promotions of an unauthorised person within the same group, or the approval of authorised firms' own promotions for communication by unauthorised persons.

HM Treasury acknowledges that this is a significant change, and intends to apply a transitional period, made up of three phases. Before the transitional period commences, there will be an application window, in which firms that wish to continue to approve financial promotions under the new regime will apply to do so. Next, during the transitional period existing firms that have applied to the FCA to be able to approve financial promotions by the end of the application window will be able to continue approving financial promotions until such time as their application is decided. Finally, at the end of the transitional period, the new regime will commence, and only those firms that have successfully applied to have the financial promotion requirement cancelled or varied will be able to approve financial promotions.

The changes will require some amendments to legislation and to FCA rules. HM Treasury notes that the government will bring forward legislation when parliamentary time allows, and the FCA will consult on its proposals in due course. Private banks that approve financial promotions should note this upcoming change and start to consider whether they would need to remove the restriction entirely or in part.

Deposit Aggregators: Joint Dear CEO Letter to Banks

On 14 April 2021, the FCA and the PRA jointly published a Dear CEO letter highlighting the risks associated with the increasing volume of deposits that are placed with banks and building societies through deposit aggregators.

Deposit aggregators are providers of intermediary services that sit between savings account providers and retail customers. The regulators are concerned that customers who place their deposits via an aggregator may not fully understand how the relationship works or that, for example, FSCS payments can take longer for deposits placed by an aggregator under a trust model. The regulators are also concerned about financial promotions, as aggregators may advertise deposit accounts on a firm's behalf.

Key watch points include:

- Firms must perform an appropriate degree of due diligence on the deposit aggregators with whom they have relationships.
- If an aggregator (which may be unregulated) makes financial promotions as a firm's agent with the aim of attracting deposits for that firm, it is the firm's responsibility as principal to comply with the applicable rules on financial promotions.
- Firms must ensure that any information provided on FSCS protection is fair, clear, and not misleading.
- Firms must consider their obligations to prepare for resolution, as they may need to plan ahead with aggregators to enable a swift pay-out via the FSCS in the event of failure.
- Deposits from aggregators could present a concentrated liquidity risk, so firms should factor this possibility into their management of liquidity risk.
- Senior management are expected to have appropriate oversight over relationships with deposit aggregators.

Private banks should consider their own use of deposit aggregators and ensure that they take into account the considerations raised by the regulators. They should also be prepared to demonstrate to the regulators any action they have taken in response to the letter.

Prudential Regulation: PRA Discussion Paper on Prudential Framework for Smaller Banks

On 29 April 2021, the PRA published a Discussion Paper (DP1/21) that explores options for developing a simpler prudential framework for non-systemic banks and building societies. The PRA explains that the regime would be designed for firms that are small and not internationally active, although it has yet to decide how it would define these terms.

The PRA's intention would be to develop a strong and simple framework that is fully consistent with the Basel Core Principles for Effective Banking Supervision, but simpler than the Basel standards that apply to large and internationally active banks. A key aim for the PRA is to develop a framework that is flexible enough to accommodate different business models, both now and in future.

The PRA's long-term vision is of a strong and simple framework in which requirements expand and become more sophisticated as the size and/or complexity of firms increase.

The PRA has identified two potential approaches to the design of a new regime. One would be a "streamlined" approach that takes the existing prudential framework as a starting point and modifies any elements that are overly complex for smaller firms. For capital adequacy requirements, this might be achieved by simplifying the current Pillar 1 and Pillar 2A risk weighted capital requirements. Similarly, for liquidity requirements this could involve simplifying the LCR and NSFR requirements.

The other option would be a "focused" approach based on a much narrower but more conservatively calibrated set of prudential requirements. This could involve establishing a simple, standard capital requirement measure that is relatively risk insensitive but conservatively calibrated, and setting a single micro-prudential buffer at the same level for all firms. Similarly, this could involve a single liquidity requirement.

The PRA notes that some elements would need to be included under both approaches. For example, the scope for simplifying requirements relating to governance, operational resilience, and recovery and resolution planning would be limited. However, the PRA is considering whether there may be scope to reduce mandatory prudential disclosures.

The PRA is at a very early stage in its planning, and has stated that it is open to ideas. Consequently, now is a good time for smaller private banks to engage with the regulator as to how the regime might be simplified for smaller firms. Private banks should consider what elements of the current regime are unduly complex and burdensome, and how they could be simplified.

The PRA's long-term vision is of a strong and simple framework in which requirements expand and become more sophisticated as the size and/or complexity of firms increase. Given the fundamental nature of the proposed change in approach, the PRA is considering starting by developing a simpler regime for the smallest firms. Once proposals for this regime are developed, the PRA will look to build out the other layers of the strong and simple framework.

Comments are requested by 9 July 2021. The PRA plans to publish a summary of the comments received, and would look to publish a consultation paper at a later date. This consultation would set out the proposed scope and requirements of a regime for the smallest firms. The PRA notes that design and implementation of any new prudential regime is likely to take a number of years to complete. Private banks should keep a watch on any developments in this area to understand if and how they might benefit from them.

Regulatory Reform: Financial Services Act 2021

On 29 April 2021, the Financial Services Act 2021 was made into law. The Act is an omnibus piece of legislation that includes an array of amendments to the existing financial services framework. While the UK government heralded the Act as a "major milestone in shaping a regulatory framework for UK financial services outside of the EU", in general it is a collection of smaller measures that introduce incremental changes, and does not represent fundamental reform.

Nevertheless, the Act brings in some important changes, which private banks should note. These include:

- **Benchmarks:** The Act grants the FCA additional powers to help with the orderly wind-down of critical benchmarks, such as LIBOR. The FCA plans to use these powers to introduce a synthetic LIBOR for use in "tough legacy" contracts. The Act also extends the transitional period for third country benchmarks under the UK Benchmarks Regulation from 31 December 2022 to 31 December 2025.
- **PRIIPs:** The Act grants the FCA powers to make rules specifying whether a product, or category of product, falls within the definition of a PRIIP for the purposes of the UK PRIIPs Regulation. As such, the FCA will have the power to clarify the scope of the Regulation and it is hoped that this will reduce the uncertainties and unintended consequences of the PRIIPs regime. The changes also remove the obligation for PRIIPs manufacturers to produce performance scenarios, due to widely held concerns that such scenarios present misleading information to investors.
- **MAR:** The Act amends UK MAR to align with some of the changes recently made to EU MAR. These include clarifying who must draw up and maintain insider lists, and the timing for disclosure of PDMR transactions. The Act also increases the maximum criminal penalty for market abuse from seven to 10 years (although no commencement date has been set for this change).
- **BNPL:** The Act provides the necessary legal basis for buy-now-pay-later (BNPL) products to be brought within the scope of regulation, as recommended by the Woolard Review (see more on this in the March 2021 edition of Private Bank Briefing).

Retail: EU Strategy for Retail Investors

On 20 April 2021, the European Commission launched a new initiative focused on improving the current framework for retail investors in the EU. The initiative aims to ensure that consumers who invest in capital markets can do so with confidence and trust, that market outcomes are improved, and that consumer participation is increased. The Commission believes that furthering this initiative will help the process of economic recovery following the COVID-19 pandemic.

The consultation covers a wide range of issues, including many key investor protection measures across a range of regimes.

The consultation on the initiative seeks views on a number of issues, including:

- The limited comparability of similar investment products that are regulated by different legislation and subject to different disclosure requirements, which prevents individual investors from making effective comparisons. The Commission also asks questions about the utility of various disclosure documents, including key information documents, the volume of information provided to investors, and the medium in which this information is provided.
- How to ensure access to fair advice in light of inducement practices, and whether introducing a ban on inducements would be desirable. The Commission also asks questions about the regulation of robo-advice.
- How to address the fact that many individuals lack sufficient financial literacy to make good decisions about personal finances. This ties in with consideration as to whether measures should be taken to facilitate access to simpler investment products for retail investors.
- Whether the PRIIPs Regulation has met its core objectives, and how the PRIIPs KID might be improved. The Commission also asks questions about costs for product manufacturers in terms of producing and updating a KID, the approach to multi-option products, whether pension products should be included in scope of the Regulation, and whether retail investors should be granted access to past versions of KIDs.
- Concerns that suitability assessments are perceived as lengthy and ineffective. The Commission asks for details of any problems with suitability assessments, and also whether the appropriateness test serves retail investor needs effectively.
- The appropriateness of the existing investor categorisation framework, and whether a new category of semi-professional investor should be introduced (following up on the findings of the MiFID Refit work in this area).
- The impact of increased digitalisation of financial services, and the potential risks and benefits of open finance. In particular, the Commission asks whether disclosure documents should be available in machine-readable format, and whether a lack of harmonisation regarding marketing and advertising rules inhibits access to investment products across the EU.
- Sustainable investing, and what factors might help investors take informed decisions regarding sustainable investments. The Commission also asks whether the MiFID II research regime should be reinforced to ensure that ESG criteria are always considered.
- The consultation covers a wide range of issues, including many key investor protection measures across a range of regimes. Any changes arising from this work could have a significant impact on firms offering investment services. Private banks operating in the EU should consider feeding into the consultation to influence how these regimes could develop in future.

The public consultation runs until 3 August 2021. The Commission plans to adopt any relevant measures in Q2 2022.

Consumer Protection: FCA Consults on New Consumer Duty

On 14 May 2021, the FCA published a Consultation Paper (CP21/13) on introducing a new Consumer Duty. This consultation is intended to fulfil the FCA's new statutory obligation to consult on whether or not to introduce a duty of care in financial services and is covered in further detail in Latham's related blog post.

The FCA makes clear that it intends to use the new rules and guidance to hold firms to higher standards.

The FCA is consulting on a package of measures, including a Consumer Principle and supporting rules and guidance (referred to collectively as the Consumer Duty). The FCA is consulting on two options for the Consumer Principle, which would likely sit alongside the existing Principles for Businesses:

1. A firm must act to deliver good outcomes for retail clients.
2. A firm must act in the best interests of retail clients.

To underpin the new Principle, the FCA is proposing cross-cutting rules, requiring that firms take all reasonable steps to avoid causing foreseeable harm to customers, take all reasonable steps to enable customers to pursue their financial objectives, and act in good faith towards customers. It is also proposing a set of four outcomes, relating to communications, products and services, customer service, and pricing.

The FCA is proposing that the Consumer Duty would apply in relation to products and services sold to retail clients. However, the relevant nexus will be whether a firm can, through its regulated activities, influence material aspects of the design, target market, or performance of a product or service that will be used by retail clients, so not only firms directly serving retail clients will be caught.

Private banks should consider the impact that this new Duty could have on their business. While in many ways the proposed new rules and guidance overlap with existing provisions, the FCA makes clear that it intends to use the new rules and guidance to hold firms to higher standards. The detailed measures accompanying the new Principle will require firms to focus on potential consumer outcomes and work backwards from there, obliging firms to focus much more readily on anticipating and preventing harm. This will require more testing and monitoring, and analysis on consumer behaviours. The FCA will expect firms to go further than at present in terms of taking consumer protection to the heart of how they design, develop, and market products to consumers.

The FCA requests feedback by 31 July 2021, and plans to issue a further consultation in which it will set out proposed drafting for the new rules and guidance by the end of the year. The FCA plans to make any new rules in this area by 31 July 2022.

Complaints: Financial Ombudsman Service Annual Complaints Data

On 25 May 2021, the Financial Ombudsman Service (FOS) published its annual complaints data for 2020/21. The FOS reports that there was a 66% increase in complaints about banking and credit. Current accounts were the most complained-about product, while unaffordable lending was the most complained-about issue. The FOS makes some important points in its analysis of the data that private banks should take into account when considering their own services.

The FOS reveals that more than 18,000 of the 170,648 banking complaints related to fraud and scams. It emphasises that it still sees the Lending Standards Board's Contingent Reimbursement Model code applied inconsistently, and that if someone has been a victim of an authorised push payment scam, a firm's starting point should be to reimburse them.

The FOS also reports high levels of complaints about administration and customer service. While the FOS acknowledges that firms saw unprecedented challenges due to the COVID-19 pandemic, it explains that many of the complaints might have been avoided with better communication to manage customers' expectations about delays or service changes.

The FOS also highlights that where complaints were upheld, the firm typically hadn't addressed what had gone wrong, or had suggested a way forward that was not right for the particular customer. Private banks should consider these issues when reviewing their own service to customers.

Asset Protection: Dormant Assets Bill

As covered in the March 2021 edition of Private Bank Briefing, the UK government is planning to expand the dormant assets scheme to include a wider range of asset classes across several sectors. The Dormant Assets Bill is currently making its way through Parliament to effect this expansion.

At present, the Dormant Bank and Building Society Accounts Act 2008 limits the scope of the scheme to dormant bank and building society accounts. However, the government is seeking to expand the scheme to accept a wider range of dormant assets, including certain assets in the pensions, investment and wealth management, and securities sectors. The Bill would bring the following assets in scope:

TYPE OF ASSET		WHEN ARE THEY CONSIDERED DORMANT?
Pension benefits	An income withdrawal that has become payable	The person in respect of whom the benefits are payable is deceased, or presumed deceased, and there is no beneficiary An income withdrawal can also be classed as dormant if at least seven years have passed since the end of the contractual term and there has been no communication from the owner or anyone acting on their behalf since that time
	A personal pension with money purchase arrangements that has become payable	
	A personal pension with money purchase arrangements available to become payable	
Investment assets	Share or unit conversion proceeds, converted to cash in line with relevant terms and provisions	The owner has been "gone-away" for at least 12 years
	A redemption proceed	The owner has been "gone-away" for at least six years Orphan monies may also be transferred immediately, if the owner's other investment assets held by the institution have already been classed as dormant and transferred to the scheme
	A distribution of income	
	Orphan monies	
Client money		The institution is satisfied that the owner has been "gone-away" for at least six years
Securities assets	Share conversion proceeds, converted to cash in line with relevant articles, terms, and/or provisions	The shareholder has been identified as "gone-away" for at least 12 years
	A cash distribution from a share	
	Proceeds from corporate actions	At least 12 years after the company was notified of the consideration and the proceeds have remained unclaimed If the share to which the corporate action proceeds relate has already been transferred to the scheme

Private banks should follow the development of this legislation, and consider how changes to the scheme could be integrated into their current dormant asset policies and procedures.

Lessons from Enforcement: Firm Fined for Sending Unwanted Marketing Emails

On 20 May 2021, the Information Commissioner's Office (ICO) announced that it had fined American Express Services Europe Limited (Amex) £90,000 for sending over 4 million unwanted marketing emails.

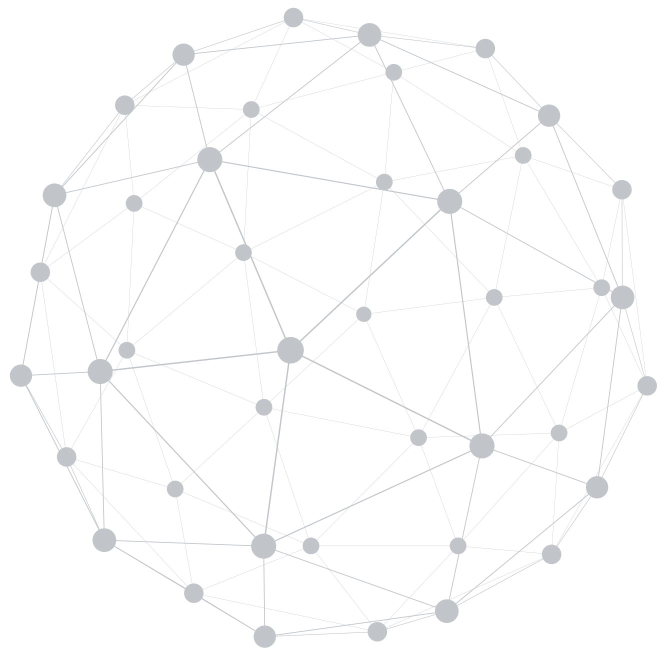
This case demonstrates the importance of categorising customer communications correctly.

The ICO focused on over 50 million servicing emails sent by Amex to its customers, finding that over 4 million of these were in fact marketing emails, designed to encourage customers to make purchases using their Amex cards. Amex had received complaints from customers who said they should not be receiving marketing emails as they had opted out of marketing communications. However, Amex rejected these complaints, saying the communications were servicing emails. The ICO found that Amex failed to review its marketing model following the customer complaints.

The ICO emphasises that servicing communications contain information such as changes to terms and conditions or notice of service interruptions, whereas marketing is defined as any communication of advertising or marketing material. The ICO found that the emails in question were clearly marketing, and that sending these emails to all customers, including those who had asked not to receive any marketing communications, was a deliberate action for financial gain.

This case demonstrates the importance of categorising customer communications correctly, and the ICO urges all businesses to familiarise themselves with the differences between a service email and a marketing email, and ensure their email communications with customers are compliant with the law. The case serves as an important reminder for private banks to ensure that marketing communications are not sent without consent. As such, private banks should consider periodically reviewing customer communications to ensure that they are compliant.

TechTrends: UK Explores Potential Central Bank Digital Currency



On 19 April 2021, the Bank of England and HM Treasury announced that they have formed a joint taskforce to explore the potential creation of a UK Central Bank Digital Currency (CBDC). No decision has yet been made in the UK as to whether to introduce a CBDC, and the aim of the taskforce is to ensure that a strategic approach is taken to the considerations at play. Given the decline of cash in recent years (and more so as a result of the COVID-19 pandemic), the Bank of England is considering whether to issue a CBDC so as to retain public money that is available to citizens and capable of general use. Many other jurisdictions are also thinking about whether to introduce a CBDC, and Latham discussed the considerations around a potential digital euro in the December 2020 edition of Private Bank Briefing. Although there are a large number of issues to contend with, it seems as though it is more a question of "when" rather than "if" CBDCs will be launched.

There are various factors to take into account, including any potential impact on financial stability, ensuring privacy and security, and how a CBDC could help deliver interoperability, innovation, and competitive outcomes as part of a future payments landscape.

As explained in a recent speech by Sir Jon Cunliffe, the Bank of England has to consider whether the benefits of introducing a CBDC outweigh the risks of letting useable, state-issued public money disappear. There are various factors to take into account, including any potential impact on financial stability, ensuring privacy and security, and how a CBDC could help deliver interoperability, innovation, and competitive outcomes as part of a future payments landscape. The Bank will also need to consider how a CBDC would be set up and what features it would have. The Bank has already confirmed that, if a CBDC were to be introduced, it would be used alongside cash and bank deposits, rather than replacing them. The CBDC would be denominated in pounds sterling and would always hold the same value as the cash equivalent. Therefore, the focus in the UK is on creating a new form of money that could be widely used, and viewed almost as a digital banknote.

The Bank of England published a Discussion Paper in 2020 on introducing a CBDC, with an illustrative model of what a general purpose public digital currency might look like. Feedback from that paper indicated that the use case for a CBDC needs further research, refinement, and articulation, to inform a comprehensive assessment of the pros and cons. The Bank published a further Discussion Paper on 7 June 2021 to gather views on its emerging thinking in this area. The paper addresses a range of topics, including the role of money in the economy, public policy objectives, and the potential impact on macroeconomic stability. While responses to the 2020 Discussion Paper reveal that views on the opportunities, risks, and design choices associated with CBDC vary, there are some areas of significant agreement where a large majority of respondents expressed a similar view. The Bank has distilled these into five core principles, which will be taken into account in the Bank's ongoing work:

1. Financial inclusion should be a prominent consideration in the design of any CBDC.
2. A competitive CBDC ecosystem with a diverse set of participants will support innovation and offer the best chance to diver the benefits of CBDC.
3. In assessing the case for CBDC, due recognition should be given to the value of other payments innovations, and their ability to deliver the benefits the Bank of England seeks.
4. CBDC should protect users' privacy.
5. Opportunities to better meet the Bank of England's policy objectives should be considered as part of CBDC exploration, even if these are not a primary consideration.

The taskforce will help to ensure that the relevant UK authorities coordinate their approach as views develop. In particular, the taskforce will:

- Help examine the objectives, use cases, benefits, and risks of a CBDC
- Guide evaluation of the necessary design features of a CBDC
- Support a thorough assessment of the overall case for introducing a CBDC

The introduction of a CBDC in the UK would present a major change in the current payments ecosystem.

Alongside the taskforce, the Bank of England has created an engagement forum to gather input from senior stakeholders on all non-technology aspects of CBDC, as well as a technology forum to gather input on all technology aspects.

The introduction of a CBDC in the UK would present a major change in the current payments ecosystem and could have a significant impact on banks, payment providers, and the public alike. Given the fundamental considerations at stake, it will take time for matters to progress. However, a recent report commissioned by the government suggested that the UK needs to be a standard-setter in this area, and recommended that a pilot scheme for a UK CBDC should be launched within 12-18 months. Private banks will want to follow developments closely as they unfold.

Global Insights – US

Biden Administration Shifting Focus to Climate Risks

Ever since the US rejoined the Paris Agreement on 19 February 2021, the Biden Administration has ramped up efforts to put the risks associated with climate change at the centre of its attention and policy direction.

On 19 April 2021, the US Department of the Treasury announced a Coordinated Climate Policy Strategy with a new Treasury Climate Hub and Climate Counselor reporting directly to Treasury Secretary Janet Yellen. The Hub will "bring to bear the full force of the Treasury Department on domestic and international policymaking, leveraging finance and financial risk mitigation to confront the threat of climate change". The focus will be on the broad range of its climate-related policy work, including:

- **Climate transition finance** (mobilising financial resources for climate-friendly investments at home and abroad, and prioritising the expedited transition of high-emitting sectors and industries)
- **Climate-related economic and tax policy** (leveraging economic and tax policies to support building climate-resilient infrastructure and ensuring the transition to a net-zero economy)
- **Climate-related financial risks** (understanding and mitigating the risks that climate change poses to the stability of the financial system and economy, at both US and global level)

On 22 April 2021, the White House published the U.S. International Climate Finance Plan, focusing on the provision or mobilisation of financial resources to assist developing countries to reduce or avoid greenhouse gas emissions and build resilience and adapt to the impacts of climate change. To confront "the urgency of the climate crisis", the plan aims to increase international climate finance while enhancing its impact; mobilise private finance internationally; scale back public investments in carbon-intensive fossil fuel-based energy while making capital flows consistent with low emissions and climate-resilient pathways; and enhance tracking and reporting on mobilisation and impact.

On 20 May 2021, President Biden signed into effect an Executive Order on Climate-Related Financial Risk aimed at addressing the threat that climate change poses to US financial stability. The Executive Order requires federal agencies, including financial regulators, to undertake work to advance clear and comparable disclosure of climate-related financial risks and act to mitigate such risk and its drivers. The Executive Order's "whole-of-government approach" for a government-wide climate-risk strategy calls for identifying the public and private means to achieving net carbon neutrality by 2050. To that end, the Executive Order specifically instructs Treasury Secretary Yellen to work with the Financial Stability Oversight Council (FSOC) to:

- Assess climate-related financial risks, both physical and transitional, to the stability of the US federal government and financial system
- Share climate-related financial risk information among FSOC member agencies and other executive agencies as appropriate
- Produce a report within 180 days of the order on the efforts of FSOC member agencies to integrate climate-related financial risk considerations, including any potential recommendations or current practices to enhance climate-related disclosures by regulated entities

Given the broad and ambitious initiatives launched by the Biden Administration, it will be interesting to monitor what additional climate-related obligations are placed on US public companies moving forward, such as enhanced disclosure obligations. Indeed, the SEC released its annual regulatory agenda on 11 June 2021, and at the top of the agenda are plans to issue proposed rulemaking (by October 2021) to enhance registrant disclosures regarding issuers' climate-related risks and opportunities. New disclosure requirements by the SEC, it should be noted, may or may not align with those that are or will be required by European legislation and international standards (such as those of the Task Force on Climate-related Financial Disclosures (TCFD)).

Furthermore, the Executive Order on Climate-Related Financial Risk was signed just two days after the release of the International Energy Agency's Net Zero by 2050 roadmap (a document whose importance US climate envoy John Kerry said he believed in "very deeply") and a few months before the COP26 summit in Glasgow. Given the timing, it is clear that climate-related financial risks and mandatory disclosures will continue to be a priority not only in the US, but for legislators and governments globally.

What to Look Out for in Q3 2021

- HM Treasury to consult on wholesale markets reform, including changes to UK MiFID
- FCA to set out its next steps on developing UK ESG Principles
- FCA to publish its Business Plan for 2021/22

Latham & Watkins
99 Bishopsgate
London EC2M 3XF

CONTACTS

Nicola Higgs
+44.20.7710.1154
nicola.higgs@lw.com

Rob Moulton
+44.20.7710.4523
rob.moulton@lw.com

Anne Mainwaring
+44.20.7710.1018
anne.mainwaring@lw.com

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

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