ALLEN & OVERY

The Financial Services Act 2021

The first step in shaping the UK's financial services regime post-Brexit

On 29 April 2021, the Financial Services Act 2021 (the **Act**) received Royal Assent. It is seen as the UK's first step in retaking control of the financial services regulatory framework post-Brexit and ensuring that the UK remains an "open and dynamic financial centre" while delivering on the Government's vision for a more open, technologically advanced and greener industry.

While the majority of the Act does seek to shape the regulatory framework for UK financial services outside of the EU, the legislation contains a broad range of measures unconnected to Brexit which will affect firms across the sector. In this bulletin, we consider both the Brexit-related developments and those miscellaneous areas that the Government has sought to address.

"For the first time in decades, the UK has full control of its own financial services regulation. This Act will protect people who rely on financial services day-to-day and boost the competitiveness of our dynamic global financial centre. It marks a major milestone in our plans to develop a regulatory regime that works for the UK and helps us seize new opportunities in the global economy."

John Glen, Economic Secretary to the Treasury

Background

In the run-up to a hard Brexit, the Act started life as the Financial Services (Implementation of Legislation) Bill (the **Bill**). The UK Government had always intended to legislate to clarify the status of "in-flight" EU financial services legislation. For the purposes of the Bill, "in-flight" legislation referred to:

– EU legislative measures that had been adopted by the EU, but would not apply on exit day and so did not fall within the scope of the European Union (Withdrawal Act) 2018; and

– legislative proposals that were (at that point in time) being negotiated but would not be adopted for up to two years post-Brexit.

The Bill stalled during its Parliamentary process and then fell when Parliament was prorogued on 8 October 2019. As a result, it was always expected that a new piece of legislation would be introduced into Parliament.

The Financial Services Bill was introduced to Parliament on 21 October 2020. According to the UK Government, the Financial Services Bill was designed to "ensure the UK's world-leading financial services sector continues to thrive and grasp new opportunities on the global stage". The Financial Services Bill set out a broad range of measures affecting firms across the financial sector, as well as firms seeking to maintain access to the UK after the end of the Brexit transition period.

During the course of the Financial Services Bill's passage through Parliament, a number of amendments were made, including through the introduction of provisions on the duty of care, clarification regarding the scope of payment services and the ability of the FCA to retain data under UK MAR.

Post-Brexit reforms

The UK's prudential framework

A key element of the Act are the changes to the Financial Services and Markets Act 2000 (**FSMA**) in order to establish the framework for the Investment Firms Prudential Regime (**IFPR**) and the UK implementation of the final Basel III standards.

It is worth noting that on 16 November 2020, HM Treasury, the PRA and FCA confirmed that the timelines for introducing the IFPR and implementing the Basel III reforms which make up the UK equivalent to the outstanding elements of the EU's CRR were being revised to 1 January 2022. This revision followed feedback from industry on concerns about the sheer volume of regulatory reform in 2021.

Basel III and 3.1 standards

The Act will implement those aspects of the Basel III standards (which were finalised between 2010 and 2017) that were introduced into the EU Capital Requirements Regulation but that did not apply across the EU until after the end of the Brexit transition period, and consequently have not yet been implemented in the UK. It will also implement the Basel 3.1 revisions agreed between 2017 and 2019 (for example, in relation to the calculation of risk-weighted assets) that have not yet been implemented by either the EU or the UK.

The Government and the PRA remain committed to the UK's implementation of the Basel standards. The Act enables the implementation of the outstanding Basel III and 3.1 standards by giving HM Treasury the power to repeal the elements of UK CRR that need to be updated to reflect the latest Basel standards. Following repeal, many of the updates will be implemented through rules made by the PRA. This will primarily involve technical changes to the UK prudential framework as it relates to credit risk, market risk, counterparty credit risk, operational risk, large exposures, collective investment units, liquidity standards and reporting, among others.

The Act provides powers for the PRA to make rules which apply to approved financial holding companies for the purposes of UK CRR and CRD, including sub-consolidated and consolidated prudential requirements and rules regarding matters such as governance and group risk. This power is designed to ensure the approved financial holding companies provisions, which have been introduced through the transposition of EU CRD V, can be maintained effectively over time, including for the purpose of the implementation of Basel standards.

Investment firms

As noted in HM Treasury's **policy statement** from June 2020, the prudential regulatory framework and its patchwork of exemptions has become more and more complex to navigate and is no longer fit-for-purpose for the regulation of investment firms. To address this, the EU introduced a new regime – the Investment Firms Regulation and Directive (**IFR/IFD**) – that was published in the EU's Official Journal in December 2019. The UK played an instrumental role in the introduction of the regime at the EU level. It negotiated it as a Member State and remains supportive of its intended outcomes. However, as this regime only applies from 26 June 2021 – which is after the end of the Brexit transition period – it does not automatically apply in the UK.

The Act therefore enables the introduction by the FCA of a tailored IFPR, which will apply to investment firms prudentially regulated by the FCA and their holding companies. The UK authorities only intend to deviate from the EU regime where they believe it is necessary to reflect the structure of the UK market and how it operates. HM Treasury and the PRA have confirmed that in relation to systemic investment firms they will not adopt the EU approach and require these firms to apply for authorisation as non-deposit-taking credit institutions. The authorities believe that the existing PRA designation framework (ie that such firms are PRA-designated investment firms) achieves the same outcomes sought by the EU's IFR.

The Act enables the majority of the IFPR to be specified through rules made by the FCA. This approach will mean that the FCA is responsible for designing and setting the detailed firm-level requirements that apply to FCA-regulated investment firms, as well as supervising those firms. It will also mean that the UK's prudential regulation regime for FCA-regulated investment firms is flexible, with the FCA able to update its rules to reflect industry changes. The FCA's rules will be made using its existing rule-making powers under FSMA and the new rule-making powers introduced in the Act in relation to unauthorised parent companies of FCA-regulated investment firms. The Act details the areas for which the FCA must introduce rules – for capital, liquidity, exposure to concentration risk, reporting, public disclosure, governance arrangements and remuneration policies. The FCA has issued two consultation papers with a third expected in Q3 2021.

In order to ensure the IFPR can be introduced as intended, the Act amends UK CRR to cease its application to (non PRA-designated) investment firms and extends the FCA's investigative and supervisory powers to allow it to effectively supervise the new regime and to amend rules to reflect changes to UK CRR, as instituted by the PRA.

It is worth paying particular attention to the provisions dealing with parent undertakings (both authorised and unauthorised) as set out in Schedule 2 to the Act. New provisions introduced within FSMA provide the FCA with a broad range of powers. In addition to establishing the duty on the FCA to make prudential rules in relation to parent undertakings, authorised under FSMA (for the purpose of complying with group prudential requirements), the same provision also introduces the FCA's new duty to make rules for unauthorised parent undertakings "where necessary or expedient for advancing the FCA's operational objectives". The FCA has consulted on introducing requirements for boards of UK holding companies whose group includes a UK investment firm or CPMI in Consultation Paper 21/7.

Access to financial services markets

Overseas funds regime

Currently, an overseas scheme must be 'recognised' pursuant to section 272 of FSMA before it is able to be promoted to the general public in the UK. Prior to Brexit, EEA UCITS that marketed into the UK via the passporting regime automatically become recognised when the appropriate regulator in the relevant EEA member state notified the FCA of the scheme's intention to market to UK investors. Schemes domiciled outside the EEA had to apply for recognition through a process that required a detailed assessment by the FCA of the scheme, its operator and its trustee and depositary, if there is one.

Following the end of the Brexit transition period, the UK's temporary marketing permissions regime enables EEA UCITS to continue marketing into the UK for a temporary period. This regime was originally scheduled to end at the end of 2023 but the Act extended that timeframe by an additional two years.

The existing process of recognition is not considered fit-for-purpose for the number of schemes that the Government expects will want to continue marketing into the UK beyond the end of the temporary regime. The Act therefore introduces a new Overseas Funds Regime (OFR) to allow overseas collective investment schemes to be marketed to all investors, including retail investors, in the UK market on appropriate terms. It introduces two new mechanisms – one for retail collective investment schemes, and one for money market funds. Through the OFR, HM Treasury will have the power to grant 'equivalence' to a specified category of schemes from an overseas country or territory.

UK MiFIR equivalence

The Act will amend the UK's MiFIR equivalence regime for third country investment firms so that it broadly reflects the changes introduced by the EU under the IFR. The Act provides the FCA with a power to specify reporting requirements for firms that register under the regime. It also amends the equivalence assessment criteria to reflect the changes to the UK's prudential rules as set out above as well as introducing additional powers for the FCA to impose temporary restrictions or prohibitions on, or withdraw the registration of, firms that register under the regime. Finally, the Act includes an amendment to clarify the scope of the reverse solicitation exception.

Gibraltar

In acknowledgement of Gibraltar's unique status as a UK Overseas Territory and in order to reflect current market access arrangements, the Act amends FSMA to introduce a new permanent access regime framework – the Gibraltar Authorisation Regime. This framework is intended to ensure that Gibraltarian financial services firms can access the UK's wholesale and retail markets on the basis of alignment of relevant law and practice, and close co-operation between the UK and Gibraltarian governments and regulators. It is also intended to facilitate the access of UK-based firms to the Gibraltarian market.

PRIIPs

The UK PRIIPs regime has been amended in a number of ways:

- **Scope** – while the definition of a PRIIP will remain unchanged, the FCA now has the power to clarify the scope of PRIIPs through its rule-making power. It is hoped this will enable the FCA to address existing, and potentially future, ambiguities on whether the PRIIPs regime applies to certain types of investment product.
- **"Performance scenario"** – the Act amends UK PRIIPs to replace the term 'performance scenarios and the assumptions made to produce them' with 'appropriate information on performance'. The FCA will then be able to amend the PRIIPs RTS (which set out the methodology for calculating these scenarios) to clarify what information should be provided in the KID by virtue of the power given by the Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019.
- **UCITS exemption** – UCITS are currently exempted from the requirements of the PRIIPs until 31 December 2021. The Act delegates power to HM Treasury to further extend the exemption until a date no later than 31 December 2026.

EMIR

The Act contains technical updates amending the onshored version of EMIR to improve access to clearing services, especially for smaller firms. It will require firms offering clearing services to do so in accordance with fair, reasonable, non-discriminatory and transparent terms. The FCA will have powers to make rules setting out the grounds on which commercial terms will meet this obligation. A second change to UK EMIR will ensure that trade repositories establish procedures to improve data quality and policies to ensure the orderly transfer of data between trade repositories, where necessary. The FCA has been given the power to adopt rules relating to this amendment.

Insider dealing and market abuse

The Act amends the UK MAR in a number of ways to clarify obligations and strengthen the regulation now that the UK has left the EU:

- **Maintaining insider lists** – the onshored version of MAR requires issuers or any person acting on their behalf or on their account to maintain an insider list. The use of "or" has caused confusion as some issuers' advisers are not sure whether they are required under MAR to draw up their own insider list (ie separate to the issuer's insider list). The Act amends UK MAR to clarify that issuers and any person acting on their behalf or on their account are all required to maintain such a list.
- **Transactions by senior managers** – Historically, the timing of when issuers are required to disclose transactions by their senior managers (that is, persons discharging managerial responsibilities) to the public and the timing of when those senior managers have had to inform the issuer has run concurrently. In order to provide for a more practical timeline, the Act amends UK MAR so that all issuers will now be required to disclose transactions within two working days of those transactions being notified to them by the senior managers or the persons closely associated with them.
- **Personal data** – UK MAR will no longer restrict the FCA from holding personal data collected for the purposes of UK MAR for more than five years. Such data can now only be held for as long as is necessary in general compliance with GDPR.

In addition to the above, the Act also extends the maximum criminal sentence for market abuse under the Criminal Justice Act 1993 and the Financial Services Act 2021 from seven to ten years, bringing it into line with comparable economic crimes.

Subordinate legislation made under retained direct EU legislation

The Act makes two amendments to FSMA in respect of powers to make subordinate legislation under retained direct EU legislation. The first is to amend the definition of "qualifying provision" to include regulations and rules made by HM Treasury and the regulators under new powers contained in retained direct EU legislation. This will allow HM Treasury to specify such regulations or rules for the purposes of other provisions in FSMA, so that various regulatory powers and functions under FSMA apply to provisions made in those regulations or rules. The second change amends the definition of "legislative function" to add to the existing list of legislative functions rule-making powers which the Act's amendments to retained direct EU legislation will confer on the FCA.

IBOR Transition

At the heart of the changes being made to the UK BMR is the desire to ensure that the FCA has the appropriate regulatory powers to manage and direct any wind-down period prior to eventual cessation of a critical benchmark such as LIBOR in a way that protects consumers and ensures market integrity.

In addition to revising the criteria for determining critical benchmarks, the Act makes a number of changes to the UK BMR, including:

- **Non-representativeness** – the Act provides the FCA with enhanced powers to determine that a critical benchmark is no longer representative of the market or economic reality that it is intended to measure, and that representativeness cannot be restored.
- **Article 23A benchmarks** – where the FCA has determined that a critical benchmark is at risk of becoming unrepresentative, or has become unrepresentative, and that its representativeness cannot reasonably be maintained or restored, it may designate such critical benchmark as an "Article 23A benchmark". Once such designation has taken place, the FCA has broad powers in respect of that benchmark, including the power to compel its continued provision on the basis of a modified methodology.
- **Use of Article 23A benchmarks** – the Act prohibits UK supervised entities from using an Article 23A benchmark once it has been "designated", subject to an exemption for legacy use for a period that is within the FCA's discretion.
- **Mandatory administration of a critical benchmark** – the Act provides the FCA with enhanced powers to compel a benchmark administrator to continue publication of a benchmark for ten years – doubling the current time period.
- **Prohibition on new use where administrator ceases providing critical benchmark** – the Act amends the UK BMR so that the FCA may, by publishing a notice, prohibit some or all new use of the benchmark by supervised entities – what constitutes "new use" is different for different categories of use of the benchmark.
- **Extension of transitional period** – the Act extends the expiration of the transitional period for third country benchmarks from 31 December 2022 to 31 December 2025 meaning UK supervised entities will be permitted to use benchmarks provided by third country administrators until the end of 2025.

The FCA has already established its policy framework for how it would exercise its new powers to require continued publication of critical benchmarks using a changed methodology, and when it could access those powers. On 20 May 2021, the FCA launched its consultation setting out which factors it thinks are relevant in deciding what legacy use of a permanently non-representative benchmark, such as any synthetic LIBOR, it will permit to continue. The consultation also sets out the FCA's proposed approach to using its power to prohibit new use of a critical benchmark which is ending. This power is separate to the legacy use power described above and will be particularly relevant to US dollar LIBOR, given most settings will continue in their current form until mid-2023.

Miscellaneous reforms

Variation or cancellation of Part 4A FSMA permissions

The Act contains new powers for the FCA, which will allow the UK regulator to expedite cases where it appears that an authorised firm is no longer carrying on regulated activities, and cancel or vary their authorisation as appropriate.

Duty of care

The Act introduces a requirement for the FCA to consult on whether it should make general rules providing that authorised persons owe a duty of care to consumers. The FCA's analysis of the responses to this consultation must be published by 1 January 2022, with any final rules to be made by 1 August 2022. On 14 May 2021, the FCA published its consultation paper and asks for responses by 31 July 2021. Our bulletin on the consultation can be accessed here.

Money laundering

The Act makes a number of changes to the UK money laundering regime, including:

- **Money laundering offences** – the Act amends the Proceeds of Crime Act 2002 (**POCA**) to bring payment and e-money institutions within the threshold amount provisions. Where the value of criminal property falls below the threshold amount, a payment or e-money institution will be able to do certain specified acts in relation to that property when operating an account maintained by it, without committing an offence.
- **Forfeiture of money** – the Act amends POCA and the Anti-terrorism, Crime and Security Act 2001 to extend the scope of account freezing and forfeiture powers to include accounts held at payment and e-money institutions.
- **Overseas trustees** – the Act amends the Sanctions and Anti-money Laundering Act 2018 (which establishes the framework for implementing post-Brexit sanctions and anti-money laundering policy) to ensure the continued ability of the Government to enforce and continue to make changes to regulations with extra-territorial application to overseas trustees of trusts with links to the UK.

Debt respite scheme

The Financial Guidance and Claims Act 2018 made provision for the creation of a debt respite scheme. The scheme has two connected parts, the Breathing Scheme and the Statutory Debt Repayment Plan (**SDRP**); the Act addresses the latter. The SDRP scheme introduces a new statutory debt solution in England, Wales and Northern Ireland focussed on debt repayment rather than insolvency. The Act allows regulations to be made that will (among other things) compel creditors to accept amended repayment terms and provide for a charging mechanism through which creditors will contribute to the cost of running the scheme and repayment plans.

Help to Save

The Help to Save scheme was launched in 2018 in order to promote and encourage saving among people on low incomes. The Act provides HM Treasury with the power to make regulations allowing for the balances in a matured Help to Save account (ie at the end of the four year term when the account ceases to be a Help to Save account) to be transferred to an alternative savings account in the National Savings Bank.

Buy-now-pay-later products

Following the Woolard Review, HM Treasury announced plans to bring buy-now-pay-later products within the regulatory perimeter and the Act is the vehicle designed to achieve this. The Financial Services Act 2012 provides that HM Treasury may disapply provisions of the Consumer Credit Act 1974 (CCA) in relation to an activity previously licensed under the CCA, or exempted under specified provisions of the CCA, where the activity has become a regulated activity for the purposes of the FSMA. The Act extends that power to activities set out in article 60F(2) and (3) of the FSMA (Regulated Activities) Order 2001.

Financial collateral

The Act ensures that the Financial Collateral Arrangement (No.2) Regulations 2003 are (and always were) fully valid and effective. This is intended to address concerns raised during litigation that the UK Government may have gone beyond its powers when transposing requirements related to financial collateral arrangements into UK law in 2003 given the regulations were applied to a broader class of persons than the underlying EU directive.

Payment services and the provision of cash

The Act amends the Payment Services Regulations to provide that, in certain circumstances, the provision of cash (otherwise than through an ATM) does not constitute a payment service where there is no corresponding purchase of goods and services.

Towards a better future?

There Act covers a lot of ground, and elements can be easily overlooked due to the sheer volume of initiatives that have been scooped up. While it is clearly the Government's first step in reshaping the UK's financial services framework, pivoting back to a regime which seeks to ensure flexibility by placing most requirements in regulatory rules, it also demonstrates how fragmented our regime currently is.

Onshoring the EU aquis and publishing over 80 (at the last count) statutory instruments to correct "deficiencies" without also publishing consolidated law means firms are subject to a more complex and opaque regime than pre-Brexit. The Act adds to the sheer volume of materials that the financial services industry has to have regard to be able to determine the legal and regulatory framework, without meaningfully rationalising it. Action is needed urgently to review, streamline and integrate the UK regime. In the meantime, regulatory change will continue for a good while yet.

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