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PRIVATE BANK BRIEFING

LATHAM & WATKINS

Issues Impacting the Private Bank Sector

Welcome to our quarterly round-up of legal and compliance issues impacting private banks and their clients.

In This Edition

PRIIPs: Latest Developments

Since it entered into force in 2018, the PRIIPs Regulation has raised a number of issues. These range from issues concerning the scope of the Regulation, in particular its application to corporate bonds and the impact this has had on the corporate bond market, to issues concerning the calculation methodologies and presentation requirements for the Key Information Document (KID).

The European Supervisory Authorities (ESAs) are now taking further steps to help improve the application and workings of the regime. First, the ESAs are consulting on amendments to the PRIIPs KID. In a consultation paper published on 16 October 2019, the ESAs consider what amendments could be made in relation to the requirements concerning future performance scenarios, transaction costs, and multi-option products in the KID.

The consultation only looks at potential amendments to the PRIIPs KID Regulatory Technical Standards, not to the Level 1 text, as the ESAs do not have the authority to review the Regulation itself. Therefore, although the consultation may result in some helpful improvements to the KID, it does not address more fundamental issues with the PRIIPs regime overall, such as the scope of application.

Responses to the consultation are requested by 13 January 2020. The ESAs state that they intend to conclude their review by the end of Q1 2020, with a view to submitting their proposals to the European Commission shortly afterwards. Subject to the time it takes for the EU legislative bodies to endorse the proposals, the ESAs suggest that the amendments could come into force during 2021.

Although the consultation may result in some helpful improvements to the KID, it does not address more fundamental issues with the PRIIPs regime overall, such as the scope of application.

Article 33 of the PRIIPs Regulation requires the Commission to carry out a review of the Regulation by 31 December 2019, therefore in theory the issues relating to the Regulation itself should be reviewed by the Commission shortly. However, in their consultation paper the ESAs note that, while they understand that the Commission is preparing to initiate this review, it is not expected that all of the required elements of the review will be completed by the end of the year. Consequently, the timing of the overall review of the PRIIPs Regulation remains uncertain, and it may yet be some time before all of the issues arising from the regime stand to be addressed.

Despite this, the ESAs have attempted to bring some further clarity regarding the scope of the Regulation. Shortly following the publication of the consultation paper, on 24 October 2019, the ESAs published a Supervisory Statement on the application of the PRIIPs Regulation to bonds. The statement confirms that, in the absence of any other indicators leading to a conclusion that a bond should be treated as a PRIIP, certain features should not by themselves trigger a conclusion that a bond is a PRIIP.

Despite this, the ESAs have attempted to bring some further clarity regarding the scope of the Regulation.

There has long been uncertainty in particular about whether the inclusion of a make whole provision in a corporate bond should trigger a PRIIPs determination. This is because it may be seen as subjecting the investor to fluctuations. However, this only occurs in the case of bonds terminating before maturity at the election of the issuer (rather than as part of the intended life cycle of the bond). There are strong arguments that an important distinction must be drawn between an instrument's investment objectives, and terms that govern the amount due to an investor when the issuer exercises a redemption right. The Statement from the ESAs can be seen as a sign that the EU regulators agree with those arguments.

While the Supervisory Statement is not binding in nature, the ESAs recommend that national regulators apply this guidance when supervising compliance with the requirements in the PRIIPs Regulation. As the position will not be resolved unless and until amendments are made to the Level 1 text to clarify the scope — and it is not certain if or when this might take place — this Statement is the most robust guidance available for the time being.

Advice: FCA Speech on Improving the Suitability of Financial Advice

On 12 September 2019, the FCA published a speech delivered by Debbie Gupta, the FCA's Director of Life Insurance and Financial Advice Supervision, on the suitability of financial advice. In the speech, Ms. Gupta emphasises that, although the rate of suitable advice overall is very high, it is much lower for more complex issues. The FCA has observed shortcomings in two particular areas: fact-finding and recording clients' needs and objectives, and evidencing the link between a recommendation and the client's attitude to risk. While much of the speech focuses on the particular issue of unsuitable advice in relation to defined benefit pension transfers, it includes some broader messages that are worth all advisers considering.

In relation to fact-finding, Ms. Gupta sets out a list of dos and don'ts that have wide application across the sector. In particular, she emphasises the importance of recording "soft" facts, as this gives context to the advice, and the value of recording client interactions, or at least making a record of interactions using the client's own words to provide insight into what the client really wants and needs. She also highlights the need to challenge clients, stating that the FCA expects advisers to use their expertise to support clients by correcting misunderstandings or providing further explanation when needed. In terms of don'ts, importantly, Ms. Gupta emphasises that advisers should not approach their work with assumptions or bias, and should not rely on "I just know my client" as a reason not to request or record key information.

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Private banks should ensure that individual advisers take these messages on board in their work.

LIBOR: FCA Warns on Conduct Risk Arising From LIBOR Transition

At the end of 2021, the FCA will stop compelling panel banks to contribute data to LIBOR. There is a general expectation that, after this date, some, if not all, panel banks will cease their contributions — which could lead to the demise of LIBOR. On 19 November 2019, the FCA published a new webpage with guidance for firms concerning conduct risk during the transition away from LIBOR.

The FCA explains that firms have been keen to understand the regulator's core expectations during the transition, and so it has set out a series of questions and answers on conduct risk arising from the transition.

> The FCA explains that its primary expectations of firms are that they:
>
> - Have a strategy in place and take necessary action during LIBOR transition
> - Treat customers fairly by following FCA rules and guidance

The guidance itself addresses a number of different topics, which are summarised below. Private banks should ensure that they follow the FCA's guidance and prioritise customers in their planning process.

Governance and accountability

The FCA's core expectation is that firms' senior managers and boards understand the risks associated with LIBOR transition and take appropriate action to move to alternative rates ahead of end-2021. Private banks should identify the Senior Manager responsible for overseeing LIBOR transition, and reflect this in the individual's Statement of Responsibilities.

The FCA suggests that firms consider whether any LIBOR-related risks are best addressed within existing conduct risk frameworks or whether they need a separate, dedicated programme. The FCA emphasises that, for many firms, LIBOR transition will affect their overall business strategy, and must not be viewed as a narrow legal and compliance risk.

Replacing LIBOR in existing contracts and products

The FCA's core expectation is that firms take reasonable steps to treat customers fairly. The FCA notes that firms are more likely to be able to demonstrate they have fulfilled their duty to treat customers fairly if they adopt a replacement rate that aligns with established market consensus, reached through appropriate consultation, and that is recognised as an appropriate solution by relevant national working groups. However, the FCA acknowledges that industry initiatives are ongoing and market consensus is still developing, meaning that firms may ultimately have to exercise their own judgement.

The FCA advises that firms should consider the following factors when choosing replacement rates:

- LIBOR transition should not be used as an excuse to move customers to rates that are expected to be higher than LIBOR, or otherwise to introduce inferior terms
- Firms receiving LIBOR-linked interest are not expected to give up the difference between LIBOR and SONIA, which results from the term credit risk premium that is built into the LIBOR rate, but is not built into SONIA
- Firms using fallback provisions must communicate clearly how these provisions are expected to operate and when they would take effect
- Firms will need to consider whether any unilateral variation terms (and other contractual terms being introduced to address the transition away from LIBOR) are fair for the purposes of the Consumer Rights Act 2015

Offering new products that reference alternative rates

The FCA's core expectation is that firms should be offering new products that reference risk-free and other alternative rates, rather than LIBOR-linked products. The FCA emphasises that the best way to avoid the complications of calculating and explaining fallback provisions is to avoid new LIBOR contracts that mature after end-2021.

To the extent that private banks continue to offer LIBOR-linked products that mature after end-2021, they need to consider whether these products can meet the needs of customers, and continue to perform as customers are led to expect, both leading up to and following the discontinuation of LIBOR.

Private banks should ensure that they follow the FCA's guidance and prioritise customers in their planning process.

Communicating with customers about LIBOR transition

The FCA's core expectation is that firms must communicate information to customers in a way that is clear, fair, and not misleading. The FCA does not offer any specific guidance on the timing of communications, but states that information should be presented in good time to allow customers to make informed decisions about relevant products and the risks to which they may be exposed.

The FCA expects firms that continue to offer LIBOR-linked products that mature after end-2021 to explain fully to customers what will happen in the event of LIBOR ending, and its effect on the customer. As there remains a risk that customers do not fully understand how the end of LIBOR will affect them, the FCA states that firms should consider offering alternative products.

Specifically, the FCA expects that firms:

- Engage with customers early to raise awareness, followed by increased engagement and client-specific conversations as the end of 2021 draws nearer
- Ensure that communications are clear, fair, and not misleading by, amongst other things, accurately describing the risks and impact, not disguising important information, fairly presenting alternative options, and taking into account the knowledge and expertise of the customers to whom the communication is to be made
- Ensure that client-facing staff are fully briefed and trained on the issues, and can respond to queries appropriately

Unfair Terms: FCA Publishes Undertaking on Transparency of Interest Rate Term

On 26 September 2019, the FCA published an undertaking in relation to a term in mortgage offer documentation that set out the interest rate charged for any additional secured borrowing. The FCA had concerns that the term was not sufficiently transparent, as consumers were unable to understand what rate of interest they would pay if the firm provided additional borrowing.

While many firms often think about fairness, they do not always give transparency its due consideration.

The relevant term in the contract stated, "If we agree additional borrowing, it will be charged at the interest rate applicable at the time". The FCA was concerned that this was ambiguous and afforded too much discretion to the firm to choose what interest rate to apply. The firm agreed to change the term to state that the interest rate charged for additional borrowing would be based on the firm's range of additional borrowing rates, which are set out on its website. The revised term also explains that the interest rate charged for additional borrowing could be higher than the existing interest rate a consumer is paying for their main mortgage account.

As the term had been included in contracts for over 11 years, the firm estimated that £3.4 million of redress would need to be paid to approximately 1,200 affected customers.

This undertaking is noteworthy for private banks for several reasons. First, it is an example of a term being challenged for transparency, not just fairness, under the Consumer Rights Act 2015. While many firms often think about fairness, they do not always give transparency its due consideration, particularly when using terms that require technical or legal language. Second, it demonstrates the importance of regularly reviewing contractual terms for fairness and transparency. The term in question had been in use for many years, compounding the damage caused and the cost of redress when it was found to lack transparency. Third, it shows the nuance between language that is transparent and readily comprehensible, and language that is not. No doubt the old term meant what the new term says, but the language used was too vague. This serves as yet another reminder of the importance of keeping consumer terms under review.

Consumer Protection: EBA Opinion on Disclosure of Banking Services Through Digital Means

On 23 October 2019, the European Banking Authority (EBA) published an Opinion containing recommendations to ensure that disclosure requirements in EU law take account of the increasing use of digital marketing channels for financial services.

The recommendations relate primarily to the scope and consistency of disclosure rules, the timing of disclosure, presentation format, and accessibility of information. They are based on information gathered by the EBA regarding the marketing of various banking and payment services, although the EBA notes that many of the recommendations are equally applicable to other financial services.

Amongst other things, the EBA recommends that key information should be provided at an early stage in the process, given the often expedited nature of customer decision-making processes via digital media. In terms of presentation, the EBA emphasises the need for information to be presented in a readable font size that can work on any kind of device. The EBA also recommends that firms should be required to design disclosure material in a way that does not affect its prominence, taking into account factors such as colours used.

It is clear that many firms are neglecting to think carefully enough about the user experience and how this might impact users' understanding of the products and services they are agreeing to.

The EBA suggests that the concept of "durable medium" be considered in relation to different types of device and communication channels, taking into account the practicality of the format and ensuring disclosures are downloadable in their entirety as stand-alone documents. Further, when all of the information cannot be shown on a single display screen, firms should make it necessary for users to scroll to the bottom before concluding a contract. The EBA also has specific recommendations relating to the use of hyperlinks to provide further information.

The EBA recommends that firms should be required to allow information to be downloaded, to enable consumers to store it for future reference. They should also be required to test information with the target market for the product to assess how it is understood and used, and to monitor the effectiveness of their disclosures by analysing consumer behaviour.

The recommendations have been provided to the European Commission, and will feed into the Commission's evaluation of the Distance Marketing of Financial Services Directive. Given that legislative change at EU level may take some time, the EBA encourages national regulators to consider incorporating the proposals into national requirements in order to speed up implementation.

Although it is uncertain if or when these proposals might become law, private banks should bear in mind the EBA's recommendations and consider reviewing their digital channels to see if those channels align with the EBA's best practices. Although many of the recommendations are common sense and seem straightforward, it is clear that many firms are neglecting to think carefully enough about the user experience and how this might impact users' understanding of the products and services they are agreeing to.

MAR: ESMA Consults on MAR Review Report

On 3 October 2019, ESMA launched a consultation on a number of MAR topics, as part of a planned review of the Regulation. As well as opening up various parts of the regime for discussion, the consultation also provides new guidance on certain elements of MAR, in particular the definition of inside information and the nature of the market soundings regime.

The deadline for feedback on the consultation was 29 November 2019, and it is expected that ESMA will have received a large number of responses. ESMA will use the responses to prepare a report for the European Commission in spring 2020.

ESMA held an open hearing on the consultation on 5 November 2019, at which it made clear that it is very much in listening mode, and is open to suggestions about how the regime might be improved. Although the review relates to potential changes to the Level 1 text, ESMA appears willing to receive feedback on various areas in which market participants are experiencing problems, even if this would best be dealt with by, for example, further guidance. Therefore, there could be scope for other changes to be made to the regime alongside the review process.

Topics discussed in the consultation include the following:

- **Spot FX.** One of the key controversies of the MAR review is whether MAR should be extended to include spot FX. Since spot FX is not a regulated instrument under MiFID, and since MiFID and MAR are designed to correlate, ESMA seems reluctant to recommend an extension of MAR. Indeed, it is difficult to see how the full MAR regime could work for spot FX (for example, potential issues include determining who would be the issuer of the instrument). However, there may be scope to design a bespoke regime to address regulators' concerns.
- **Definition of inside information.** There are a number of technical aspects of the definition of inside information that frequently cause difficulty in practice. However, it is likely that, in part, this is a result of deliberate drafting to ensure that a wide range of information is captured. ESMA does not propose particular revisions to the definition, rather, ESMA uses the consultation as an opportunity to give additional guidance on topics such as pre-hedging.
- **Delayed disclosure of inside information.** The Commission had expressed an interest in exploring whether, in certain situations, information is mature enough to trigger a prohibition on trading, but insufficiently mature to be disclosed to the public. This could include considering whether it might be beneficial to have two different definitions of inside information. ESMA asks for examples of cases in which identification of when information became inside information was problematic.
- **Market soundings.** ESMA takes a stance on the ongoing uncertainty over whether the regime is a safe harbour or a mandatory obligation. ESMA's view is that it is the latter, and there is likely to be significant lobbying from the industry on this point. Further, ESMA suggests making use of recorded telephone lines mandatory when carrying out market soundings.
- **Insider lists.** ESMA provides guidance that existing insider lists should only include persons who have actually accessed a piece of inside information, and not those who could potentially have done so because of their role in a support function. This echoes recent FCA statements on the same point. ESMA also looks at the role of permanent insiders and states that "only an extremely limited group of individuals should meet that definition". ESMA then names seven roles that might meet the definition, such as the CEO.
- **Managers' transactions.** ESMA suggests that persons closely associated with PDMRs should be subject to the closed period requirements, which could, in some individual circumstances, prove problematic.

MiFID II: FCA Findings From Review Into Research Unbundling Rules

On 19 September 2019, the FCA published findings from its review into how firms have implemented the MiFID II rules on research unbundling. Overall, the FCA found that the new rules, which require firms providing portfolio management and advisory services to pay for research separately from other services, have improved such firms' accountability over costs. The FCA also found that firms have improved their scrutiny of both research and execution costs, including when firms have chosen to charge research costs to clients.

Generally, the FCA acknowledges that market changes are still developing, in particular in relation to pricing.

According to the FCA, firms have reduced research expenditure across the board, with research budgets having fallen by around 20% to 30% on average. Despite this, most firms said they are still getting the research they need. The FCA deduces, therefore, that most savings must reflect greater competition and market efficiencies, including better cost discipline amongst firms. The FCA acknowledges that valuation models are still evolving, and states that it expects firms to continue developing approaches that ensure the way they buy their research is consistent with their duty to act in the best interests of their clients.

The FCA reports that it found a wide range of sell-side pricing models, with firms using tiered price brackets, "pay as you go" pricing, or pricing per interaction or product. Interestingly, despite feedback that some research is priced too low, the FCA states that low "entry level" pricing for research accompanied by higher fees for more exclusive interactions could be a reasonable pricing strategy overall.

The FCA also touches on firms' implementation of the inducements rules more widely, observing that some firms have taken an overly strict approach to deciding what constitutes an inducement. Therefore, the FCA seeks to clarify what firms are permitted to accept in terms of non-monetary benefits. In particular, the FCA encourages firms to make greater use of its specific carve-outs for research trial periods and issuer-sponsored research.

Generally, the FCA acknowledges that market changes are still developing, in particular in relation to pricing, and says it intends to carry out further work in this area in 12 to 24 months' time to assess firms' ongoing compliance with the rules.

Global Insights — US

SEC Extends No-Action Relief for Research Unbundling

On 4 November 2019, the US Securities and Exchange Commission (SEC) issued a three-year extension of the no-action relief that it previously granted in response to issues arising from the MiFID II research unbundling provisions.

The original no-action letter — issued on 26 October 2017 and scheduled to expire on 3 July 2020 — essentially meant that US broker-dealers could receive "hard dollar" payments for research from EU firms that are required by MiFID II to pay separately for research. Absent this relief, US broker-dealers receiving designated payments for research risked losing the benefit of an exemption from additional regulation by the SEC as an "investment adviser" under the US Investment Advisers Act of 1940.

While the extension continues to provide a temporary fix on these matters, significant issues remain, and it still appears that a global, long-term solution will ultimately be required.

As with the original no-action relief, however, the extension does not offer any relief to US broker-dealers that wish to unbundle research and execution charges for non-EU based asset managers, either to harmonise with their billing methodology for EU asset managers, or as a pragmatic business decision if non-EU based asset managers prefer an unbundled invoice. Thus, without additional SEC relief or statutory change, US broker-dealers that do decide to accept hard dollar payments for research or otherwise unbundle research costs from trading commissions still face the loss of the current exemption from additional regulation as investment advisers under the Advisers Act.

Therefore, while the extension continues to provide a temporary fix on these matters, significant issues remain, and it still appears that a global, long-term solution will ultimately be required.

Benchmarks: European Commission Consults on Review of the BMR

On 11 October 2019, the European Commission published a consultation on its review of the EU Benchmarks Regulation (BMR). Comments were originally requested by 6 December 2019, but the deadline was subsequently extended to 31 December 2019. Market participants, including private banks, are urged to participate in the consultation.

The review addresses the following topics:

- **Critical benchmarks.** The Commission considers whether it might be appropriate for national regulators to be able to require administrators to change the methodology of a critical benchmark that is no longer representative, and whether any decisions by the administrator to cease the provision of a critical benchmark should be subject to prior approval by national regulators. The Commission also asks whether supervised users of critical benchmarks should be required to draw up contingency plans to cover instances in which a critical benchmark ceases to be representative of its underlying market, not only to cover the situation in which there is a material change to, or cessation of, the benchmark.
- **Authorisation and registration.** The Commission is seeking views on whether national regulators should be given the power to suspend or withdraw authorisation in respect of one or more individual benchmarks, rather than only being able to suspend or withdraw the administrator's authorisation or registration in its entirety. This would mean that, if only one particular benchmark is non-compliant, the use of the rest of the administrator's benchmarks would be unaffected.
- **Scope.** Noting the broad scope of application of the BMR, and the fact that other jurisdictions have limited their benchmark regulatory regimes to the most critical or systemic financial benchmarks, the Commission is seeking feedback on scope. In particular, the Commission asks for feedback on how to address benchmarks that are not significant in terms of their use in the EU, and benchmarks that, by their nature, are less prone to manipulation.
- **The ESMA register.** The Commission is seeking views on general satisfaction with the register, and whether users would like to see a complete list of benchmarks provided by EU administrators that have obtained authorisation or registration (rather than just a list of administrators). This is an important area for firms to provide feedback, since the register should be a key source of diligence when identifying whether a benchmark is available for use in the EU.
- **Benchmark statements.** Accepting that benchmark statements vary and that the information they contain often overlaps with information disclosed in the methodology, the Commission is seeking views on how useful the benchmark statement has proved to be as a comparison tool and how it can be improved.
- **Climate-related and commodity benchmarks.** In light of the two new types of climate-related benchmarks introduced by amendments to the BMR, the Commission is gathering views as to how such benchmarks might be supervised. The Commission suggests that national regulators should have the power to prevent supervised users from referencing a climate-related benchmark if it does not meet the rules applicable to climate-related benchmarks, or the investment strategy referencing that benchmark does not align with the benchmark.

Operational Resilience: Report on IT Failures in the Financial Services Sector

On 28 October 2019, the Treasury Committee published a report on IT failures in the financial services sector. The report sets out the findings from the Treasury Committee's inquiry, which was launched following a number of high-profile and significant IT incidents. The inquiry has now been closed, due to the dissolution of Parliament prior to the general election. However, the report sets out some important observations that nevertheless remain pertinent and that private banks should take on board.

While the report acknowledges that some level of IT failure is inevitable, it concludes that the current level and frequency of disruption caused by IT failures is unacceptable. The report places a strong emphasis on the fact that customers now rely more heavily on digital channels, making it all the more important that these channels are safe and reliable.

Key findings from the report include:

- **Outsourcing.** Firms need to improve risk management of third-party relationships, given that many incidents are caused by outsourced service providers.
- **Impact of IT incidents.** Heavier reliance on digital services means that the impact of IT failures is even more acute. The number of IT failures is increasing, with results ranging from inconvenience or harm to customers, to threats to a firm's viability. The lack of consistent and accurate recording of data on such incidents is concerning.
- **Issues with legacy systems.** Firms are not doing enough to mitigate the operational risks that they face from their own legacy technology, which can often lead to IT incidents. When firms do embrace new technology, poor change management is one of the primary causes of IT failures. It is therefore crucial that firms have strong and well-rehearsed change management procedures. Firms must not use the cost or difficulty of upgrades as an excuse not to make upgrades to legacy systems.
- **Customer communications.** When incidents do occur, poor customer communications can exacerbate the situation. Firms must use clear, timely, and accurate communications to ensure that customers are aware of an incident and that they receive advice on remediation timelines and alternative access.
- **Senior management.** Holding senior management to account when IT failures occur is essential, to prevent mistakes being repeated and to focus the attention of senior managers on operational resilience. Also, remuneration structures within firms need to reflect the importance of operational resilience.
- **Regulatory supervision.** Supervision of firms' operational resilience may need to follow a different model to that for prudential and conduct risks, but should be afforded similar prominence.
- **Regulatory coordination.** Change is one of the biggest causes of operational incidents, but the regulators are one of the biggest causes of change. The regulators should not inadvertently increase the risk of incidents by placing excessive or poorly coordinated requirements on firms.
- **Concentration risk.** One of the key emerging risks to operational resilience is concentration risk, particularly amongst cloud service providers. There is a considerable case for the regulation of cloud service providers as critical infrastructure, to ensure high standards of operational resilience.

As the regulators continue their work on operational resilience, they may well use the findings from the report to develop their policy in this area, even if they are not required to do so by any future government. The regulators have previously indicated that they plan to consult on policy proposals on their expectations regarding firms' operational resilience in 2019, but have not committed to any precise timing.

Tax: HMRC Issues Further Guidance on the Taxation of Cryptoassets

On 1 November 2019, HM Revenue & Customs (HMRC) issued a policy paper on the taxation of cryptoassets for businesses and companies. This follows guidance issued by HMRC in December 2018 for individuals holding cryptoassets. The new guidance generally follows, but elaborates on, the principles laid down in the initial guidance. It is useful as it provides further clarity for companies undertaking transactions involving cryptoassets and gives tax advice in respect of certain scenarios involving cryptoassets, such as blockchain forks. The guidance addresses not only the corporation tax consequences of transactions involving cryptoassets, but also the stamp tax consequences, the VAT implications, and certain employment tax considerations.

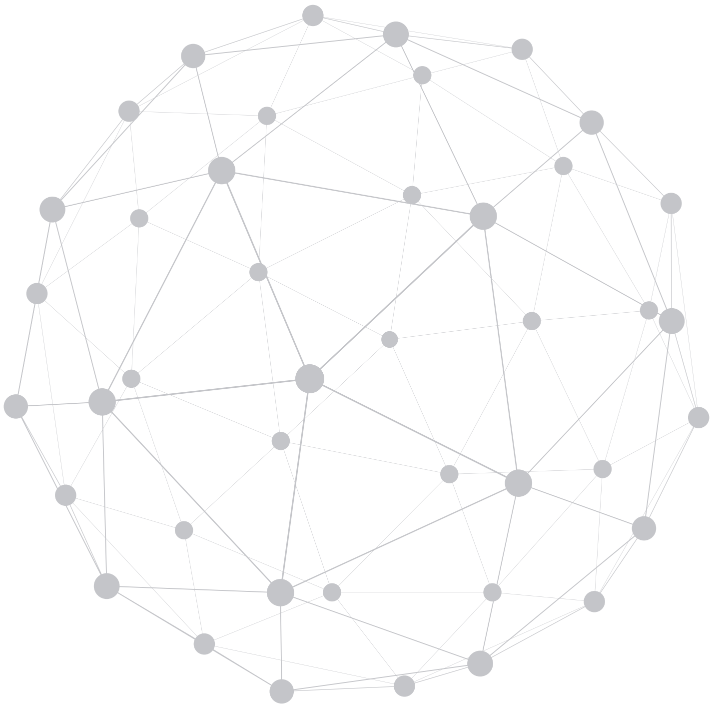
The policy paper deals specifically with the tax treatment of exchange tokens (e.g., Bitcoin). It does not apply to the issue of tokens under initial coin offerings or other similar events. The tax treatment of security tokens and utility tokens will be addressed in future guidance.

Notably, the policy paper confirms that HMRC does not consider any of the current types of cryptoassets to be money or currency for tax purposes. Therefore, any corporation tax legislation that relates solely to money or currency does not apply to exchange tokens or other types of cryptoassets. For example, a loan of exchange tokens is unlikely to constitute a "loan relationship" for tax purposes; therefore, in most cases, such a loan will not be taxed in the same way as other corporate finance transactions.

The acquisition and disposal of cryptoassets generally falls within the income tax regime or chargeable gains regime (i.e., the corporation tax equivalent of the capital gains tax regime). The question of whether a trade is being carried on — which is determined using general principles — is a key factor in ascertaining the correct tax treatment. If a person or business activity amounts to a trade, the receipts and expenses will form part of the calculation of trading profit. If the activity concerning the exchange token is not a trading activity, but rather an investment activity (and is not charged to corporation tax in another way, such as under the non-trading loan relationship or intangible fixed assets rules), then any gain arising from the disposal of the cryptoassets is a chargeable gain.

HMRC notes that the cryptoassets sector is fast-moving and developing all the time, and therefore HMRC's view may evolve further as the sector develops. Private banks should monitor the situation to keep abreast of how cryptoassets are being characterised for tax purposes and how this might impact their clients.

TechTrends: A Global Regulatory Overview of Stablecoins



An important global trend is the emergence and proliferation of stablecoins. Given their inherently data-centric and financial nature, stablecoin projects face various legal and regulatory hurdles, some of which are unique from traditional cryptocurrencies. In particular, the more recent development of "global stablecoins", which have the potential to disrupt traditional payments systems and other financial services, has provoked increased governmental and regulatory scrutiny of how best to regulate these projects. Private banks will want to monitor the direction of travel in this area to keep ahead of the impact stablecoins could have on the financial services sector.

What is a stablecoin?

A stablecoin is a cryptoasset designed to have low volatility and to consistently reflect the value of a reference asset, or assets, with identifiable value (such as currencies, commodities, or securities). By seeking to achieve price stability, stablecoins aim to overcome the significant volatility that is a key limitation preventing the adoption of cryptoassets as a means of exchange or a store of value (rather than a means of speculation).

To achieve price stability, stablecoins employ a range of stabilisation methods. Typical structures include:

- **Currency-backed:** a stablecoin backed by, and redeemable for, funds held by an issuer or custodian.
- **Asset-backed:** a stablecoin backed by traditional assets (such as commodities or securities) held by an issuer or custodian, or decentralised assets, which is either redeemable or held in a manner designed to reduce the value volatility.
- **Algorithmic:** a stablecoin with a price that reflects holders' expectations about the future purchasing power of their holdings, which does not require the custody of any underlying asset. For example, the value of a stablecoin "pegged" to an index or other measure of value may be stabilised using an algorithm that expands and contracts the circulating supply of the stablecoin in response to market behaviour.

Regulatory treatment: structure matters

Governments are grappling with the implications of stablecoin usage, including potential consumer fraud or loss, financial crime and tax evasion, competition issues, and even reduced sovereign control of monetary policy and supply. As a result, regulators face questions regarding how to apply laws and regulatory regimes that did not contemplate the technology underpinning stablecoins or their uses. Legislators also need to consider whether to tweak existing legislative frameworks or implement new ones to accommodate such technology and uses.

That said, from a regulatory perspective, the structure of a stablecoin (including the stabilisation method used) clearly matters. For example, in most major jurisdictions, whether a stablecoin is to be regulated as a security, a derivative, a stored value product, or an unregulated instrument turns on the precise structure. Generally speaking, currency-backed and asset-backed stablecoins will be regulated as a security, derivative, or stored value product.

At present, legal uncertainty regarding the treatment of stablecoins continues to exist in various jurisdictions; further, little regulatory alignment exists across jurisdictions. Stablecoin developers must reconcile whether and how their project may operate under the laws and regulations of each jurisdiction in which they will operate, or in which the stablecoin will be distributed.

The more recent development of "global stablecoins", which have the potential to disrupt traditional payments systems and other financial services, has provoked increased governmental and regulatory scrutiny.

Key developments

The emergence of stablecoins has prompted national and international reactions.

At an international level, for example, the FCA has provided specific regulatory guidance on the application of the UK regulatory framework to stablecoins. A number of jurisdictions (e.g., Gibraltar, Malta, and Hong Kong) have gone further, developing technology-specific regulatory frameworks for digital assets that may apply to stablecoins. US regulators are still grappling with the treatment of stablecoins and how they may differ from other cryptoassets.

At an international level, the policy considerations raised in reports issued by both the G7 and the Financial Stability Board are likely to provide the foundation for further work by governments and regulators in relation to stablecoins. The emergence of possible global stablecoins may be the impetus for governmental and international bodies to develop publicly issued and controlled stablecoins that digitally represent fiat currency. Two notable projects of this kind are underway, with the People's Bank of China announcing a project to issue the world's first national digital currency in 2020, and the European Central Bank announcing that it is analysing the technical aspects of a digital currency to assess the desirability and feasibility of a publicly issued cryptocurrency in the EU.

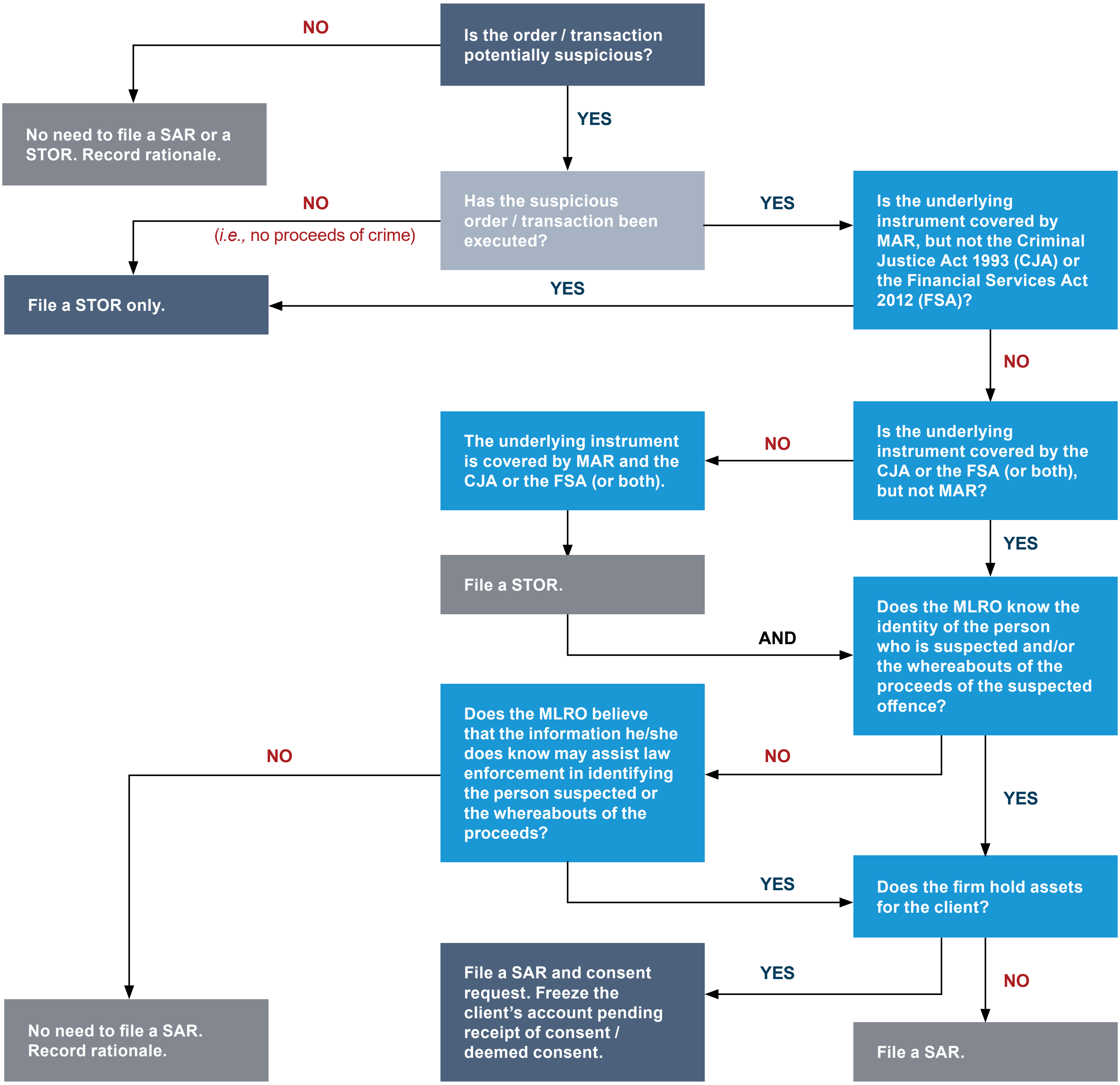
Lessons From Enforcement: STOR or SAR?

The FCA has published a letter that was sent to UK Finance on 6 September 2019. The letter clarifies the application of the suspicious activity reports (SARs) regime under the Proceeds of Crime Act 2002 and the suspicious transaction and order reports (STORs) regime under MAR, and sets out the FCA's expectations of firms in this regard.

The FCA emphasises that, as there is a significant overlap between civil and criminal offences relating to market abuse, certain market abuse behaviours may be caught as financial crime under both civil and criminal legislation. Therefore, it may be necessary to submit a STOR and a SAR in relation to a single order or transaction.

The flowchart below is designed to assist with determining whether to submit a SAR, a STOR, or both.

Filing STORs and SARs – Navigating the Overlapping Regimes



What to Look Out for in Q1 2020

- Deadline for EU Member States to implement MLD5
- Deadline for banks to upload relevant information to the FCA's new financial services Directory
- FCA expected to publish a Discussion Paper on reviewing the Principles for Businesses
- Various reports due as part of the scheduled review of certain MiFID II provisions

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