LEGAL BRIEFING

TRAVERS SMITH

Financial Services Regulation 2023 – New Year briefing

Regulatory change in the Carolean Age

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To improve is to change; to be perfect is to change often.

Winston Churchill

It is perhaps with some relief that 2022 is in the rear-view mirror. There is no doubt that it was a momentous year: Covid receded but never quite went away (in China it may be getting worse); a retrogressive war raged (and is still raging) in Ukraine; football came home for the English in July (but didn't do so in December); a winter bomb cyclone hit the US; Britain had three Prime Ministers, four Chancellors of the Exchequer and one very serious market meltdown; and the Elizabethan age came to an end after seventy years.

But it is also with some trepidation that we look forward to 2023. Aside from a cost-of-living crisis, events in the far western steppes of Europe and other geopolitical disruptions, the scope, volume and pace of ongoing regulatory change is – to use an overused word – unprecedented. It is perhaps not surprising given the context in which we find ourselves: emerging from a global pandemic looking to build back better, trying to tackle the potentially existential threat of global warming and other environmental concerns and, in the UK at least, looking to find a positive and distinct direction post-Brexit.

Few would argue with the fact that to improve is to change. Whether changing quite so often as is the case in financial services will lead to perfection is perhaps rather more debatable.

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On the horizon

In its December 2022 Financial Stability Report, the Bank of England's Financial Policy Committee (**FPC**) identified **non-bank finance** as an area of acute risk in respect of which urgent international action is required in 2023. The Bank will be looking at the resilience of non-bank financial institutions (**NBFIs**) to shocks, and how they are interconnected with banks and core markets – as with stress testing for banks, the Bank sees a need to improve stress testing risks associated with NBFIs for plausible but severe scenarios. The Bank intends to run an exploratory scenario exercise focused on NBFI risks – further details will be set out in the first half of 2023.

As a connected issue, **liability driven investment** (**LDI**) funds were identified as being of particular concern. In the September 2022 market turmoil, resulting from the government's disastrous mini-budget, rapid and large moves in the interest rates on UK government debt exposed weaknesses in the LDI funds used by UK pension schemes. The Bank concluded this in turn threatened the financial stability of the country. The FPC recommends that regulatory action should be taken by The Pensions Regulator (**TPR**) in conjunction with the FCA and non-UK regulators to ensure that LDI funds remain resilient to future interest rate shocks.

As heavily trailed, first by one Chancellor and then confirmed by his successor, the so-called **bankers' bonus cap** – the limit on the ratio of a bonus to fixed pay that applies to UK banks, building societies and designated investment firms under the Capital Requirements Directive as implemented in the UK rules – will be scrapped. On 19 December 2022, the PRA and FCA jointly consulted on the changes they propose to give effect to the removal (consultation closes on 31 March 2023). The changes are anticipated to take place in Q2 2023 and would apply to a firm's performance year starting after that – for most, that is likely to be performance years starting in 2024.

While the reform of bankers' bonus restrictions will not concern most investment firms, the one-year-old prudential regime specifically designed for them will. The new UK **Investment Firms Prudential Regime** came into effect on 1 January 2022 and during 2022 firms have been busy familiarising themselves with MIFIDPRU and getting to grips with its requirements. This will continue, but those firms who have been relying on MIFIDPRU transitional provisions will find themselves possibly needing to increase their capital levels as transitional relief tapers and having to make many MIFIDPRU disclosures for the first time in 2023, including MIFIDPRU remuneration disclosures, risk management and investment policy disclosures.

The PRA/Bank of England/FCA discussion paper on **diversity and inclusion** in the financial sector seems a long time ago now (July 2021). The regulator had originally planned on publishing a consultation paper in Q1 2022 and a policy statement, with draft rules, in Q3 2022. This timetable obviously slipped. On 12 December 2022, the FCA published a webpage Understanding approaches to D&I in financial services setting out its findings of the pilot data survey on how financial services firms are designing and embedding D&I strategies based on a sample of twelve firms (eight with large pay gaps and four with relatively small pay gaps). The sampled firms will receive feedback letters. On the webpage the FCA confirmed that its long-

awaited consultation on proposals resulting from its discussion paper will be published "in 2023".

Another initiative that was floated some time ago, and which seems to have gone rather quiet, relates to possible amendments to the UK's "**overseas person exclusion**" (the **OPE**) as part of changes to the overall overseas framework. In December 2020, HM Treasury published a Call for Evidence seeking to understand how the overseas framework supports the UK's position as a global financial centre. That framework is constituted by several separate, but connected, regimes, including the OPE, the Financial Promotion Order and "equivalence" under UK MiFIR. The Treasury published the response to the Call for Evidence in July 2021, saying it would be reviewing the overseas regulatory perimeter and then consulting on potential changes in Q4 2021 – including any proposed changes to the OPE. An update was given in December 2021 saying that the government and regulators were still gathering information and still thinking about it. In its July 2022 Perimeter Report the FCA said that it has been working with the Treasury in preparation for its consultation on the UK's overseas framework and expects the consultation to consider whether further oversight and regulatory powers are needed for the OPE regime. So, the consultation is still coming and perhaps, like the D&I consultation, 2023 will eventually be the year for change.

In this briefing – a summary

In the area of **ESG and sustainable finance** there is much talk about the desirability of achieving some degree of homogenisation between the various legislative and regulatory frameworks that exist, or are being developed, globally. But the truth is that, despite familiar concepts across the board, devilish details distinguish one jurisdiction's regime from another. The EU stole a march here and its legislative infrastructure is the most developed, most sophisticated, and most detailed; but the bloc's lead here also landed it with a "first mover *dis*advantage" as it was the first to confront the very real headaches associated with implementation of the requirements and the absence, in many cases, of the data needed to fulfil the mandatory disclosures. **See Part 3: ESG and Sustainable Finance**

Close to the top of everyone's watch list – in the UK at least – is the future of **financial services regulation**. Following Brexit, a great deal hangs on the direction that the UK will take. The **Financial Services and Markets Bill** – which is currently progressing through Parliament – was touted by the then Chancellor, Rishi Sunak, as "Big Bang 2.0". Yet while the Bill was still in its early stages, Kwasi Kwarteng – in his brief tenure as Chancellor – was talking about wanting a "Big Bang 2.0", as something evidently different, or more than, the Bill. And then, when the package of Edinburgh reforms was unveiled, the commentators were asking "is this Big Bang 2.0?" Notably, the current Chancellor, Jeremy Hunt, did not use the term. Another popular post-Brexit rallying cry is that we should have a "Bonfire of Regulation", getting rid of the EU "red tape" that the UK "inherited" from the EU. The **Retained EU Law (Revocation and Reform) Bill** might be rather closer to such a bonfire than the Financial Services and Markets Bill is, at least in terms of intent, but, for the most part, financial services seem to be carved out. In any event,

there is a growing belief that the ambitious target of revoking most retained EU law by the end of 2023 will not be met. So, maybe not a bonfire and perhaps nothing will be burned unless there is something to replace it. However, further substantial changes will be coming – the Edinburgh reform package announced in December 2022 is wide-ranging and includes consideration of some specific measures that will go beyond what is currently contemplated in the Financial Services and Markets Bill. **See Part 1: UK Financial Services Regulation: Legislative Reform**

Aside from Big Bangs and bonfires, it is business as usual at the FCA. Except that, in many ways, it has been anything but usual. Big policy initiatives, requiring significant investment by affected firms in regulatory change projects, have been the order of the day. The **Consumer Duty** – which isn't really just about consumers – will mark a sea change in the way that firms will be expected to deal with their customers and investors. The first implementation date is 31 July 2023. It is clear the FCA wants to see a fundamental shift in culture. The **changes to the Appointed Representative regime** are already in force, subject to some transitioning. Principal firms now need to have a close eye on the activities of their ARs, to complete self-assessments about how they are complying with the enhanced requirements and to report much more information to the regulator. The FCA has also overhauled its **financial promotion rules**, particularly (but not exclusively) in relation to higher-risk investments. Although some rules in relation to risk warnings are already in force, the bulk of the changes come into force on 1 February 2023. The FCA has also consulted on how it sees the **financial promotions gateway** (as contemplated by the Financial Services and Markets Bill) operating – i.e. the basis on which firms will only be able to approve financial promotions on behalf of unauthorised persons if they are specifically permitted to do so. The FCA is also thinking about introducing a **new core investment advice regime** under which firms would be subject to a lighter touch regulatory regime if advising on "plain vanilla" investments held within a new stocks and shares ISA wrapper. This is still out for consultation, but if the FCA goes ahead as planned, firms will be able to start providing the new service from April 2024. **See Part 2: UK Financial Services Regulation: FCA Rules**

At a more workaday level, some firms may continue to find delays – often quite considerable ones – when dealing with the Authorisations Division at the FCA. The regulator's Authorisations Update in October 2022 suggested that several factors have contributed to such delays but that it is now "near target" in meeting at least some of the statutorily prescribed service metrics, such as applications for: Part 4A permission, variations of permission (**VoPs**), money laundering registrations and change in control. Individual experiences may not yet reflect these apparent improvements in the overall statistics (and, as regards change in control applications in particular, the FCA issued an update in December 2022 on the delays there have been in allocating notifications to case officers in recent months). The FCA concedes that it has not been meeting "other service metrics" (which presumably means that it is not "near target" regarding any of these at the moment). These include those relating to approved person status, appointed representatives and applications under the Payment Services Regulations and Electronic Money Regulations. Some of these service metrics are voluntary rather than statutory

and the FCA says that it is reviewing former: for instance, it says that the voluntary service metric of 5 calendar days for dealing with approved person controlled function/significant influence function applications "is no longer achievable" because of the increased scrutiny the FCA applies to such applications. The Authorisations Update sets out areas where the FCA is working to improve assessment times so, hopefully, 2023 will see further reductions in the time firms spend waiting for approvals. Other evidence from firms suggests that, perhaps because of the FCA's more "data driven" approach, there appears to be an increase in very granular questioning from the regulator.

Much has been happening in the **investment funds** industry. The amendments to the **Alternative Investment Fund Managers Directive** (**AIFMD II**) and the **European Long Term Investment Fund** (**ELTIF**) continue. AIFMD II is likely to apply in 2025. The UK Treasury has proposed to review the UK Funds Regime (timing currently uncertain) and there are proposed amendments to the **Long-Term Asset Funds** regime. As part of the Edinburgh reforms, HM Treasury has consulted on its intention to **repeal the UK PRIIPs Regulation** and asks what should replace it? And, across the pond, the SEC has announced that its **no-action letter in respect of investment research** will expire on 3 July 2023. UK and EU firms that have been relying on the letter in order to procure research may need to restructure their arrangements. See **Part 4: Investment Funds**

When it comes to **prudential matters**, aside from the "bedding down" of the UK IFPR regime, things have been quieter than before, though fund managers may be interested in the **EU CRR RTS on the calculation of risk-weighted exposure amounts of CIUs** which will set out how EU credit institutions calculate RWA under the mandate approach and/or in the PRA's specific proposals as to how it intends to implement the **Basel 3.1 standards as regards risk weights for unlisted equities/CIU investments** in the UK. See **Part 5: Prudential**

As regards the **MiFID II regime** governing EU investment firms, two EU legislative proposals are currently being negotiated between the EU institutions which will amend MiFID II and MiFIR largely to enhance the provisions governing market data access and trade transparency (not covered in this briefing). ESMA has consulted on potential amendments to the **technical standards on cross-border services and passporting**. In the UK, an SI that will revoke Article 62 of the UK MiFID Org Regulation is expected to come into force in January 2023. This will remove the requirement for firms to issue 10% depreciation notices to investors. The FCA has been operating temporary measures in respect of that requirement since March 2020 and recently extended them pending the revocation of Article 62. Bigger changes are in the pipeline. When the Financial Services and Market Bill is enacted, the UK MiFID II regime will be subject to some immediate changes to the wholesale trading rules and, in time, will be subject to the revocation and replacement approach that will be adopted in relation to most retained EU law. See **Part 6: MiFID II**

The regulation of the plumbing of the financial markets, and its plumbers – **Financial Markets Infrastructure** – continues apace. Under **EU CSDR** the **settlement discipline regime** has been tricky – the **mandatory buy-in rules** component of that regime has proved especially problematic and has resulted in deferral of those rules until November 2025. In addition to

looking again at the settlement discipline regime, the **proposal to amend EU CSDR** will address passporting and the position of third-country CSDs and prudential and organisation requirements. In the UK, new rules are due on **outsourcing and third-party risk management for FMIs** and on an **extension of SM&CR to FMIs**. The government will be responding during the course of this year on its **consultation on payments regulation and the systemic perimeter** – this will likely see an extension in scope of the perimeter to capture additional entities that operate within payment chains and are considered systemically important. After a postponement, the **migration of CHAPS payments to ISO 20022** messaging will now happen on 19 June 2023, after which the introduction of the new RTGS core ledger and settlement engine is now scheduled for spring 2024. **Confirmation of Payee** coverage will be extended to capture an additional 400 PSPs, with the first group being required to comply from 31 October 2023 at the latest. In its December 2022 Annual Report on the supervision of FMIs, the Bank of England set out its (unsurprising) future priorities in this area: delivering robust, risk-based supervision of FMIs and enhancing the supervisory approach; enhancing CCP resilience, recovery and resolution; facilitating safe innovation in payments and settlements; and continuing to cooperate with international partners to promote safe, efficient, and open global markets. **See Part 7: Financial Markets Infrastructure**

When it comes to **Fintech**, there are plenty of hard regulatory initiatives coming into force within the next two or three years in the EU, whereas in the UK it is perhaps fair to say that things are still at the discussion stage. That said, the latest version of the Financial Services and Markets Bill contains new provisions which would empower HM Treasury to designate activities in relation to cryptoassets as regulated activities, to include cryptoassets in the new designated activities regime and to extend the scope of the financial promotion restriction to cover cryptoasset promotions. There is therefore a possibility that the UK may be looking to introduce more wholesale regulation of cryptoasset-related activities sooner than previously envisaged, in a departure from the more incremental, systemic risk-driven approach we have seen to date.

The **EU Regulation on a Pilot Regime for DLT Market Infrastructures** will start applying on 23 March 2023. The **Regulation on Digital Operational Resilience** (affectionately abbreviated as **DORA**), which will set out operational resilience requirements for firms in their use of ICT services (and requirements for certain third parties providing such services), will apply as from 17 January 2025. The **Regulation on Markets in Cryptoassets (MiCA)** will establish a new regime to regulate those providing services related to cryptoassets or offering or issuing certain cryptoassets in the EU – the timing on this seems to have slipped a little, so this may not start applying until 2024/2025. In the UK, the Law Commission has issued a 550-page consultation paper setting out **proposals for law reform in respect of digital assets**. A month later, the UK Jurisdiction Taskforce of LawtechUK published a consultation on a proposed **Legal Statement on Digital Securities**. It also remains to be seen what changes, if any, to regulation in the cryptoasset space in the EU and UK might be prompted by high-profile collapses such as FTX towards the end of 2022 and the Terra "algorithmic stablecoin" prior to that. At a global level, CPMI and IOSCO published their **Final Guidance on the application of the Principles for**

Financial Market Infrastructures to systemically important stablecoin arrangements. **See Part 8: Fintech**

Under the general heading **Markets and Trading** the European Commission has issued its **Report on the functioning of the EU Securitisation Regulation** – while the number of material legislative changes suggested at this stage are limited, there are some potentially significant points that will require monitoring and the Commission *does* intend to make some changes on the "next revision" of the regulation. This will be particularly to clarify the jurisdictional scope both from sell-side and buy-side perspectives (including in relation to AIFM investors). Securitisation is one of the areas where we may see a material deviation between the approach adopted in the EU and, based on the Treasury's work to date and the fact that an overhaul seems likely given that the UK Securitisation Regulation is on the list of Edinburgh Reforms, the approach adopted in the UK. Another area where the EU and UK could be drifting further apart relates to short selling: in the UK the Treasury has embarked upon a review of the UK Short Selling Regulation by calling for evidence, with a view to identifying what should replace the EU-derived legislation (again, this is just one of the elements of the Edinburgh Reforms package). **See Part 9: Markets and Trading**

Both the EU and UK have been looking to enhance their AML/CFT regimes. The **EU's new package of AML/CTF proposals** will see the establishment of a new central authority – **AMLA** – which, in addition to its co-ordinating role and some direct supervisory powers, will be responsible for developing technical standards, guidelines and recommendations. Much of what is currently in MLD 5 will migrate to a new, directly applicable **AML/CTF Regulation**, while a Sixth Money Laundering Directive (**MLD 6**) will set out some new requirements. In the UK, some "time sensitive" updates have been made to the Money Laundering Regulations 2017 (**MLRs**), the majority of which will come into force on 1 April 2023. These include new requirements for firms to assess and record the **risks of proliferation financing** (financing the proliferation of weapons of mass destruction) and enhanced requirements to report **material deficiencies** (between information on a register and information the firm has). Provisions relating to transfers of cryptoassets will come into force on 1 September 2023. The Treasury is undertaking a slower, longer-dated review of the MLRs so additional amendments may be forthcoming in due course. Finally, the wide-ranging **Economic Crime and Corporate Transparency Bill 2022** is progressing through Parliament. The Bill includes several provisions specifically relevant to financial services – for instance, HM Treasury will be empowered to make amendments to the **list of high-risk countries** for money laundering purposes (as currently set out in a schedule to the MLRs and in respect of which enhanced due diligence is required) without the need for a statutory instrument. **See Part 10: Money Laundering and Financial Crime**

MAIN INDEX

1 UK FINANCIAL SERVICES REGULATION: LEGISLATIVE REFORM

Financial Services and Markets Bill

WHAT IS THIS? UK legislation providing for a major overhaul of the UK's regulatory framework for financial services.

WHO DOES THIS APPLY TO? Authorised financial services firms principally but some parts also apply in respect of unauthorised persons.

WHEN DOES THIS APPLY? Not yet known.

The UK government published its long-awaited Financial Services and Markets Bill (**FSM Bill**) in July 2022 which included a large number of measures that will effect a major overhaul of the UK's regulatory framework for financial services. Many of the measures introduced in the Bill reflect the government's consultations over the past few years, including those on the Future Framework Review, the Wholesale Markets Review and the regulatory framework for the approval of financial promotions.

The Bill also provides a framework for the UK's post-Brexit financial services regime, including the repeal of retained EU financial services legislation and the migration of much of that law from the statute book into the UK financial services regulators' rulebooks. However, the FSM Bill does not set out a timetable for completing this task. The entire process is likely to take a number of years and the government has said that it intends to take a balanced approach and not pursue change for its own sake. This is expected to focus on 43 core areas of regulation and the process has already started with the Securitisation Regulation, the prospectus regime, Solvency II and work to implement the Wholesale Markets Review (which involves reforming the MiFID framework). According to HM Treasury's policy statement on building a smarter financial services framework for the UK, the next phase includes the Packaged Retail and Insurance-Based Investment Products Regulation (**UK PRIIPs**), the Payment Services Directive, the E-Money Directive, the Capital Requirements Regulation and Directive, the Long-Term Investment Funds Regulation and the Short Selling Regulation. Significant progress is expected on these first two phases by the end of 2023.

In addition, the FSM Bill provides for several new regulatory regimes including for the approval of financial promotions, the regulation of "designated activities" and additional powers for the UK financial services regulators in respect of critical third-party service providers. The government's fintech initiatives are also reflected through provisions to bring certain activities connected with digital settlement assets into the regulatory framework (and this has been subsequently expanded further – see below). A number of measures relevant to financial market infrastructure operators are also included as well as new powers and objectives for the UK financial services regulators.

Although the proposals will mainly be relevant to authorised financial services firms, it is worth noting that some of the proposals such as the new designated activities regime and powers in respect of critical third-party service providers will also be relevant to non-authorised persons.

As regards the UK financial services regulators, there are several provisions which generally relate to the regulation of the regulators, giving them new powers but making them subject to additional obligations and oversight. The question of oversight has provided controversial and the possibility of "call-in powers" permitting government ministers to override the UK financial services regulators were discussed, heavily criticised, and ultimately abandoned.

We considered the key points of the original FSM Bill in more detail in our August 2022 briefing.

A revised version of the FSM Bill was published in November 2022 which included a new provision in respect of cryptoassets which would allow HM Treasury to extend the scope of the financial promotion restriction to include cryptoassets, to designate activities in respect of cryptoassets as regulated activities and to include cryptoassets in the new designated activities regime. There would also be a new definition of cryptoasset: "*any cryptographically secured digital representation of value or contractual rights that (a) can be transferred, stored or traded electronically, and (b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)*". This new definition would potentially cover a far broader range of digital assets than have been the focus of UK regulation to date, reflecting both the UK's ambition for an expansive fintech regime as well as concerns around the consumer protection and systemic implications of cryptoasset activity. A consultation on a broader regulatory regime for cryptoassets is expected in early 2023.

The revised FSM Bill is now with the House of Lords and includes some additional provisions tabled as part of the parliamentary process. The most significant of these is a power for HM Treasury to implement a regime for unauthorised co-ownership alternative investment funds (**AIFs**) which suggests that a professional investor fund may be introduced in the short to medium term.

Retained EU Law (Revocation and Reform) Bill

WHAT IS THIS? Proposals to revoke EU legislation and remove other EU derived legal provisions from UK law.

WHO DOES THIS APPLY TO? Everyone.

WHEN DOES THIS APPLY? Official deadline is 31 December 2023.

In September 2022, the government published its highly ambitious Retained EU Law (Revocation and Reform) Bill (**EU Law Bill**) which, broadly, aims to reset the status of EU law in the UK legal system.

The key headline is the proposed revocation of retained EU law by the end of 2023 although many doubts have already been expressed (including by members of the government) as to how feasible – and desirable – this is. The EU Law Bill itself provides for this deadline to be extended in certain cases to 2026 and, if the EU Law Bill continues in its current form, it seems likely that this will be used.

Under the EU Law Bill, EU-derived subordinate legislation and retained direct EU legislation will be revoked on 31 December 2023 unless specifically exempted. There are also powers for the restatement or updating of currently retained secondary EU law so that it remains part of UK law. The government would also have the power to revoke secondary retained EU law and replace it with a provision that it considers appropriate and which achieves the same objectives (or an alternative provision that it considers appropriate). However, any replacement must not increase the relevant regulatory burden.

Crucially, most financial services legislation is excluded from the general revocation including provisions referred to in Schedule 1 of the FSM Bill; any rules made by the Financial Conduct Authority (**FCA**), the Prudential Regulation Authority (**PRA**) or the Bank of England; and generally applicable requirements or directions of general application from the Payment Systems Regulator. Schedule 1 of the FSM Bill includes, by way of example, the Alternative Investment Fund Managers Regulation, Market Abuse Regulation, the Markets in Financial Instruments Regulation, and the Central Securities Depositories Regulation, as well as implementing provisions made under the Markets in Financial Instruments Directive, the UCITS Directive, the Alternative Investment Fund Managers Directive (**AIFMD**), the Settlement Finality Directive and the Payment Services Directive (**PSD2**). Certain technical standards and other "*EU derived legislation [...] so far as relating to financial services or markets*" are also caught. Although there is a question as to whether the list in Schedule 1 is fully comprehensive, it seems that the government's intention is to exclude all financial services related legislation from the EU Law Bill.

The EU Law Bill also provides for the repeal of the principle of supremacy of EU law from UK law and new principles for the interpretation of retained EU law as well as additional abilities for higher courts to depart from retained EU case law.

Finally, the EU Law Bill would also repeal directly effective EU law rights and obligations – broadly those derived from case law or from the principle of direct effect – as from the end of 2023.

We discussed the EU Law Bill in more depth in our briefing.

Edinburgh Reforms

WHAT IS THIS? A package of financial services reforms announced by the UK government.

WHO DOES THIS APPLY TO? Varies.

WHEN DOES THIS APPLY? Individual reforms will have their own application dates.

On 9 December 2022, the Chancellor of the Exchequer, Jeremy Hunt, announced the so-called Edinburgh Reforms which set out around 30 proposed changes to the UK financial services regime over the next few years. These are intended to build on the FSM Bill and boost growth in the financial services sector post-Brexit.

A full list is set out in our briefing and a number of measures are mentioned elsewhere in this briefing; but key regulatory measures include reform of the UK Securitisation Regulation, repeal of the UK PRIIPs Regulation (see UK PRIIPs and UK Retail Disclosure below), reform of the UK Short Selling Regulation, an independent Investment Research Review and a possible UK retail central bank digital currency.

A review of the Senior Managers and Certification Regime (**SM&CR**) was also announced – with the focus expected to be largely on banks.

2 UK FINANCIAL SERVICES REGULATION: FCA RULES

FCA Consumer Duty

WHAT IS THIS? A new high-level Principle and rules and guidance that will require in-scope firms to deliver good outcomes for "retail customers".

WHO DOES THIS APPLY TO? All firms that deal with "retail customers" either direct, or through distribution chains, in respect of "retail market business" – the scope of the new definitions will mean that what some firms might consider to be wholesale business will be caught.

WHEN DOES THIS APPLY? 31 July 2023, for all new and existing products and services that are open for sale or renewal on that date. 31 July 2024, for all products and services held in closed books.

In July 2022, the FCA published PS22/9: A new Consumer Duty, setting out its feedback to its December 2021 consultation in CP21/36 and attaching its final rules. To accompany the final rules, the FCA also published FG22/5: Final non-Handbook Guidance for firms on the Consumer Duty.

The scope of application of the Consumer Duty is broader than those words "consumer" and "retail" might first imply, with extended definitions of "retail customer" in certain areas, most notably in the funds and occupational pensions sectors.

Implementation

For those firms that will be caught, the countdown to implementation is (or should be) well underway:

- By the **end of April 2023**: manufacturers should have completed all reviews necessary to meet the relevant rules for all existing open products and services to enable them to share with their distributors all the information necessary for the latter to meet their obligations under the Consumer Duty and identify what changes need to be made to their existing open products and services, so that those changes can be effected by the first implementation date.
- From **31 July 2023 – first implementation date (open products/services):** this is when the rules and guidance come into force for all new and existing products and services that are open for sale or renewal on that date. However, the regulatory change project will not be complete then: a second implementation wave will follow.

- From **31 July 2024 – second implementation date (closed products/services):** this is when the rules and guidance come into force in respect of all products and services held in "closed books".

Even those firms that are able to scope themselves out, by way of the definitions and exemptions, will nonetheless need to remain aware of the perimeters of the new regime; and they will have to have regard to the Duty when opting-up customers to elective professional customers or when considering entering new lines of business or marketing to new, wider pools of capital (such as those fund managers looking to "retailise" some of their fund offerings). Furthermore, such firms may well need to look again at the basis on which they managed to scope themselves out – as noted below, five months after the publication of the supposedly final rules, on 2 December 2022, the FCA published a quarterly consultation paper which includes a proposal substantially to amend one of the exemptions – see below.

Elements of the regime

The new regime is ambitious and will mark a sea change in the way that in-scope firms will be expected to deal with "retail customers": there will be a new Consumer Principle that will require firms to act to deliver good outcomes for retail customers. Detailed rules and guidance underpin that Principle. Where applicable, the Consumer Duty regime will displace existing consumer-protection rules in the Handbook, such as those giving effect to Principle 6 (a firm must pay due regard to the interests of its customers and treat them fairly) and Principle 7 (a firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading). Yet those rules remain in force and will continue to be relevant to situations where the Consumer Duty does not apply. There is therefore "mutual exclusivity" between the Consumer Duty regime and the raft of existing consumer-protection rules. At the same time, many of the new rules have an air of familiarity about them. Most notably, the products and services customer outcome rules incorporate many concepts set out in the product governance requirements in the product governance sourcebook (**PROD**) and, indeed, where relevant, in-scope firms are permitted to choose to continue to comply with the requirements of PROD *in lieu* of the Consumer Duty requirements. Elements of the price and value outcome rules resemble those existing rules that apply to authorised fund managers in respect of authorised funds, QIS and LTAFs and, again, such managers are relieved from complying with the Consumer Duty rules because of their existing compliance obligations under the collective investment schemes sourcebook (**COLL**). The new rules on consumer understanding also build on existing concepts. Despite some of these existing "regulatory tropes", however, the new rules do go further and are more detailed than any existing requirements. They are also more coherently part of a distinct regime.

Aside from the heavy lift that the new regime necessitates from an operational perspective, it is clear that the regulator is expecting to see a major shift in culture from firms. The next couple of years or so will be a challenging period for the regulator and the regulated alike as the new regime beds down.

For more detail, see our September 2022 briefing: The new FCA Consumer Duty: a higher, standard, better culture and good outcomes. This predated the FCA's latest proposed amendments as set out in its December quarterly consultation (see below).

Quarterly consultation amendments

As mentioned above, on 2 December 2022, the FCA published CP22/26: Quarterly Consultation No 38, which included a section on proposed changes to the Consumer Duty rules. The consultation period for these particular proposals was set at only for five weeks: the deadline for comments is **9 January 2023**.

One of the proposed amendments relates to the so-called £50,000 exemption. The Consumer Duty only applies to a firm's "retail market business": activities carried on in relation to "non-retail financial instruments" are expressly excluded from that definition. Under the rules published in July, one of the limbs of the definition of "non-retail financial instrument" relates to financial instruments in respect of which a minimum denomination or otherwise a minimum investment of £50,000 applies (or equivalent amount where the financial instrument is denominated in other currency) – hence the "£50,000 exemption".

In the quarterly consultation paper, the FCA proposed the disapplication of that exemption where the financial instrument is a unit or share in a collective investment scheme or AIF. It argued that it did not intend the exclusion to cover instances where firms are designing and distributing funds for retail customers.

If this proposal is taken forward as drafted, many asset managers which had previously assessed themselves as being out of scope on the basis that the minimum investment in their funds was at least £50,000 will need to reconsider their position and, unless they can rely on another exemption, may find that they will need to comply with the Consumer Duty, with all that that entails in terms of cross-cutting rules and the retail customer outcome rules. The rules start to apply on 31 July 2023. It is likely that there will be vociferous push back on this proposal. It is not a foregone conclusion that the proposal will be taken forward as drafted (or at all), so for the time being there is a period of uncertainty.

It is fair to say that the other proposed changes to the Consumer Duty regime were somewhat overshadowed by the proposed deletion of the £50,000 exemption for investment funds:

- One of these relates to a proposed amendment to the additional application provisions in PRIN 3.2.6 to make it clear (by stating in rule form for the first time) that specified sections of the Consumer Duty (such as the cross-cutting rules and the consumer understanding outcome rules) apply to firms involved in the communication and approval of financial promotions which are addressed to, or disseminated in such a way that they are likely to be received by, a retail customer (as defined in the context of the Consumer Duty). Despite ostensibly being a "clarification", there are aspect of this proposal that firms may wish to push back on.

- The FCA has also proposed a tweak to the definition of "retail customer" in the context of an occupational pension scheme to clarify that "retail customer" means any person who is not a client of the firm but who is or would be a beneficiary of that scheme. The current definition, which refers to beneficiaries "*in relation to investments held in*" the occupational pension scheme is potentially misleading since, while members are undoubtedly beneficiaries of the trust-based scheme operated by the OPS trustee, they do not have any direct property rights in relation to the assets of the scheme. The FCA says that the amendment is therefore in recognition of the fact that there might be some scope for misinterpretation in relation to defined benefit (**DB**) occupational pension schemes. Having suggested such a clarification, the FCA goes on to say that in practice, it does not expect there to be many instances where FCA authorised firms have a material influence on retail customer outcomes in relation to DB occupational pension schemes, but that it cannot discount the possibility and so will not provide a blanket exclusion for DB occupational pension schemes. For authorised firms carrying on activities in relation to occupational pension schemes, whether DB or defined contribution (**DC**), it is likely that a case-by-case analysis will be required in order to determine whether the Consumer Duty applies.

Portfolio and sector-specific letters to firms

The FCA has announced that it will be publishing a package of portfolio and sector-specific letters to firms early in 2023, setting out its expectations for implementation. The letters will also address the FCA's findings from its review of firms' implementation plans.

The Appointed Representatives regime: changes

WHAT IS THIS? Changes to the FCA's rules on appointed representatives (**ARs**) requiring new notification and reporting requirements, enhanced oversight of ARs and new requirements in relation to AR agreements.

WHO DOES THIS APPLY TO? All firms with ARs (including tied agents).

WHEN DOES THIS APPLY? 8 December 2022, subject to transitional arrangements for certain changes.

Changes to FCA's regulatory regime

Outline

In early August 2022, the FCA published PS22/11: Improvements to the Appointed Representatives regime, setting out its feedback following its December 2021 consultation and containing the final rules, which are now all in force.

The changes have resulted in significantly more onerous information and notification requirements, heightened requirements on firms to oversee their ARs (including the requirement

to conduct self-assessments and carry out annual reviews) and provisions regarding the content of AR agreements.

The rules came into force on **8 December 2022**, though some of the individual requirements will be subject to transitional provisions which will have the effect of delaying the date of first compliance. For instance, principals are required to verify the details of their ARs on the Financial Services Register on an annual basis – however, broadly, firms will not be required to report this information until their first accounting reference date on or after 1 December 2023.

More details – our briefing

More details on the FCA changes that are now in force (the majority of which are included in the rules in Chapter 12 of the Supervision Manual (**SUP 12**)) are contained in our briefing, The Appointed Representatives Regime: FCA Policy Statement.

Mandatory Section 165 requests

One of the notification requirements relates to the obligation to give 30 days prior notification to the FCA of a proposed appointment of a *new* AR. However, the FCA made it clear that, as regards *existing ARs*, they would be collecting broadly the same information through a section 165 FSMA request. Firms were told to expect to receive such section 165 data requests between 8 December and 12 December 2022, addressed to the Principal User on Connect. The deadline for responding to such section 165 data requests is **28 February 2023**.

Future regulatory changes?

This is unlikely to be the end of changes to the AR regime from the regulator. The FCA policy statement contained a summary of responses it had received on several areas of discussion for potential future change, but which were not addressed in the final rules. These included feedback on the following issues:

- The wider implications of the regulatory hosting model (beyond the limited notification provisions that were included in the final rules).
- The use of the regulatory hosting model specifically in the context of the investment management sector – the consultation had looked at the use of the host AIFM model and the secondment of staff between the principal and its AR.
- The concerns that the regulator has with larger ARs that have proportionately much smaller principals.
- Issues arising from the appointment of overseas ARs.
- Enhancing prudential standards for principals – i.e. whether prudential standards should be introduced, or enhanced, to reflect the risks arising from business models using ARs.

The FCA is pointedly keeping its powder dry on these points and is not providing its views on any of the feedback at this stage. So, there may be more proposals in the pipeline which will be subject to a future consultation and/or policy statement, though probably not until the PS22/11 changes have bedded down and changes to the statutory regime, if any, (see below) have been made.

Changes to the statutory regime

In addition, the FCA is continuing to work with HM Treasury on potential changes to the legislative regime governing ARs. Back in 2021, HM Treasury had published a Call for Evidence on the AR regime in which, among other things, it had raised the possibility of changing the law in the following areas:

- Changing the scope of regulated activities in relation to which ARs can be appointed.
- Introducing a new, specific permission for firms to act as principal.
- Extending parts of the Senior Managers & Certification Regime (**SMCR**) to the AR regime.
- Extending the jurisdiction of the Financial Ombudsman Service to cover ARs.

At the time of writing, Treasury feedback on the call for evidence is still awaited.

UK Financial Promotions Regime – FCA rules

WHAT IS THIS? Changes to the FCA's financial promotions rules in respect of higher risk investments and the communication and approval of financial promotions.

WHO DOES THIS APPLY TO? FCA authorised firms approving and communicating financial promotions.

WHEN DOES THIS APPLY? 1 December 2022 for the risk warnings for higher risk investments and 1 February 2023 for the remaining changes.

The FCA has issued new rules on financial promotions as set out in PS22/10: Strengthening our financial promotion rules for high-risk investments and firms approving financial promotions.

The new rules follow concerns that consumers are investing in products (including certain speculative cryptoassets and illiquid securities) that are too risky for them and therefore are being exposed to significant losses. The rules therefore aim to prevent inappropriate investments being offered to consumers and also to ensure that consumers are aware of the risks involved. They also support the approach in the FCA's new Consumer Duty (discussed in FCA Consumer Duty above).

The new rules include prescribed and detailed risk warnings for higher risk investments marketed to retail clients which came into force on 1 December 2022. The FCA clarified in late December that there had been an error in the drafting of certain of the new rules and that "*excluded communications*" (which includes those made under an exclusion in the Financial Promotion Order or Promotion of Collective Investment Schemes Order) do not need to include the risk warnings for non-mainstream pooled investments and speculative illiquid securities.

The rules on prescribed and detailed risk warnings will be followed on **1 February 2023** with three new product classifications for the purposes of the financial promotion rules: Readily Realisable Securities, Restricted Mass Market Investments and Non-Mass Market Investments which will form the basis of new restrictions on marketing higher risk investments to retail clients. The FCA states that these new classifications are intended to rationalise and simplify the marketing restrictions applicable to firms which, over the past few years, have become increasingly unwieldy and difficult for firms to navigate. Whether this will be the result in practice remains to be seen.

Additional rules relating to the communication and approval of financial promotions by FCA authorised firms will also apply as from **1 February 2023**.

In due course, some of the requirements will also be extended to cryptoassets but this is dependent on the relevant legislation being passed.

We discuss these provisions in more detail on our briefing.

UK Financial Promotions Gateway

WHAT IS THIS? A proposed framework under which authorised firms may only approve financial promotions on behalf of unauthorised persons if, and to the extent that, they have permission from the FCA to do so.

WHO DOES THIS APPLY TO? FCA authorised firms wishing to approve financial promotions.

WHEN DOES THIS APPLY? Not yet known.

The FSM Bill includes a proposed framework for a "gateway" for authorised firms approving financial promotions under which firms will only be able to approve financial promotions if, and to the extent that, they have specific permission from the FCA to do so. In December 2022, the FCA issued CP22/27 setting out how it envisages this gateway working in practice.

The purpose of the gateway is to address concerns that authorised firms have been approving poor quality financial promotions which do not comply with FCA rules and which, as a result, are causing harm to investors (particularly consumers).

Under the proposals, all firms will be subject to a restriction on their permission, known as the Financial Promotion Requirement (**FPR**), restricting them from approving financial promotions. Existing firms wishing to approve financial promotions will therefore need to apply for a variation of permission (following the usual process) and firms seeking authorisation for the first time will be able to apply as part of their Part 4A application.

As mentioned above, if enacted, the FPR will apply to all authorised firms including those which are already authorised and are approving financial promotions currently. There will be a transitional regime including an application period (**Application Period**) during which existing authorised firms will be able to apply for permission to approve financial promotions (although it is not currently known how long the Application Period will last). Such firms will then be able to continue to approve promotions pending a decision from the FCA (which may take up to 12 months). If a firm does not apply for permission to approve financial promotions during the Application Period, it will be subject to the FPR restriction once the Application Period has ended.

Firms will be able to apply for permission to approve all types of financial promotions or just promotions for certain types of products. However, the FCA has said that it considers it unlikely that many firms will have the competence and expertise to approve all types of promotions. The FCA may approve an application in full or may indicate that it would only approve it on a more limited basis. The FCA will also have the power to vary the terms of or cancel the permission.

Some exemptions are expected to apply to the requirement to apply for permission, including where a firm approves its own financial promotions for communication by an unauthorised person, where a firm approves financial promotions for an affiliate and for certain promotions by the firm's appointed representatives.

There will also be reporting and notification requirements. These include an obligation to notify to the FCA, within one week of approval, certain details of each financial promotion approved on behalf of an unauthorised person, including the relevant product name and type and details of the unauthorised person. Further notifications will need to be made in the case of amendments to, or withdrawal of approval of, such financial promotions. There will also be half-yearly aggregate reporting requirements, including the total number of approvals, total number of customer complaints and revenue from financial promotion approval activity.

The consultation closes on 7 February 2023 with the final rules expected in the first half of 2023 although this will ultimately be subject to the progress of the FSM Bill.

Discussion paper on Operational Resilience for Critical Third Parties

WHAT IS THIS? Powers for the UK financial services supervisors to impose operational resilience requirements on service providers to authorised firms and FMIs.

WHO DOES THIS APPLY TO? Service providers to authorised firms and FMIs.

WHEN DOES THIS APPLY? Not yet known.

The FCA, the Bank of England (in its capacity as supervisor of financial market infrastructures (**FMIs**)) and the PRA (the **Supervisory Authorities**) issued a joint discussion paper (DP3/22) on Operational Resilience: Critical third parties to the UK financial sector in July 2022. This builds on the additional powers for the Supervisory Authorities in respect of critical third-party service providers (**CTPs**) in the FSM Bill and sets out how those powers would be used in practice.

The new powers are in response to the increasing reliance of financial services firms on third parties outside the finance sector – such as cloud-based computing and communications technology service providers – to support their regulated activities. The UK government and the Supervisory Authorities are very aware that any failure or disruption in the services provided by those third parties could ultimately threaten the stability of the UK financial system and harm consumers. Therefore, they consider that they need greater direct oversight of the services provided by certain third parties to firms and FMIs which they deem critical to the financial sector. The Supervisory Authorities expect that the new regime will (initially at least) will only apply to a very small percentage of third-party service providers such as the major cloud service providers.

According to the discussion paper, the regime may potentially apply to non-UK domiciled service providers providing services to UK firms and FMIs on a cross-border basis as well as UK domiciled service providers. It is not currently envisaged that there will be any requirements for CTPs to have entities, infrastructure, personnel, or services in the UK, but it is unclear at this stage how any supervision of non-UK service providers would operate in practice.

The new regime is intended to operate in addition to, and not replace, the responsibilities of firms and FMIs under the specific operational resilience rules applicable to them.

The discussion paper includes a framework for the Supervisory Authorities to identify potential third parties for designation as critical by HM Treasury, minimum resilience standards for designated CTPs and proposed tools to test the resilience of the material services provided by designated CTPs.

We discuss the proposals further in our briefing. A consultation is expected in 2023.

Significant SYSC firms and enhanced scope SMCR firms

WHAT IS THIS? Amendments to clarify that only "significant SYSC firms" that would have been both significant IFPRU firms and IFPRU investment firms under the pre-IFPR rules will satisfy the conditions making them enhanced scope SMCR firms.

WHO DOES THIS APPLY TO? Relevant to those significant SYSC firms needing to determine whether they are enhanced scope SMCR firms.

WHEN DOES THIS APPLY? Date to be appointed – policy statement and final rules awaited.

On 2 September 2022, CP22/17: Quarterly Consultation No 37, included a three-week consultation on proposed amendments to SYSC Annex 1 designed to clarify the qualification conditions for determining whether a firm is an enhanced scope SMCR firm. At the moment, one of those qualifying conditions is that a firm is a "significant SYSC firm", as defined, meeting certain threshold conditions.

By way of background, when the UK IFPR regime came into force on 1 January 2022, the Prudential Sourcebook for Investment Firms (IFPRU) was deleted. Prior to that deletion, the definition of "significant IFPRU firm", as relevant to that sourcebook, had been set out in IFPRU 1.2; however, that definition had also been used as one of the criteria for identifying an enhanced scope SMCR firm. So, if a firm was a "significant IFPRU firm" for the purposes of IFPRU (and it met the threshold conditions) it was also an enhanced scope SMCR firm.

Given the fact that IFPRU was to be deleted, the FCA essentially changed the name of the definition from "significant IFPRU firm" to "significant SYSC firm" and moved it into SYSC 1.5. In doing so, the FCA's expressed policy intent at the time had been to maintain the application of the enhanced scope SMCR regime precisely as it was before the implementation of IFPRU.

However, the renaming and migration of the definition resulted in an unintended increase in the scope of application of the enhanced scope SMCR regime so that it appeared to catch a significant number of firms that had not been IFPRU firms but that nonetheless exceeded one or more the relevant thresholds set out in the definition of enhanced scope SMCR firm: this included AIFMs, adviser-arrangers and segregated portfolio managers.

Various representations were made to the FCA last year, finally culminating in an acknowledgment from the regulator that there had been an unintended increase in scope which the quarterly consultation amendments were intended to fix.

In outline, the proposed amendments introduce additional qualifying criteria into SYSC 23 Annex 1, Part 7 to the effect that, if a firm is a significant SYSC firm by definition, it must also meet both of the following conditions if it is also to be an enhanced scope SMCR firm:

- it must be an "investment firm", as defined in article 4(1)(2) of the UK Capital Requirements Regulation – this includes a collective portfolio management investment (CPMI) firm (i.e. an AIFM or UCITS management company with MiFID "top-up" permissions); and

- it is not excluded by any of the new exclusions inserted into SYSC 23 Annex 9.4R – i.e., essentially, it is not:
    - A local firm; or
    - A firm authorised to provide reception and transmission of orders, portfolio management and/or investment advice and no other investment service, is not authorised to carry on safeguarding of financial instruments and is not permitted to hold client money or securities.

The amendments to SYSC also contain guidance to the effect that the purpose of the relevant criteria referred to above is to replicate the main part of the definition of 'IFPRU investment firm'.

The changes therefore give effect to the FCA's intention that it is that only those firms that would have been both significant IFPRU firms and IFPRU investment firms under the pre-IFPR arrangements that should potentially be subject to the enhanced scope SMCR regime.

At the timing of writing, we are still awaiting the final rules.

FCA consultation: guidance on the trading venue perimeter

WHAT IS THIS? Consultation on guidance on the trading venue perimeter, as part of the Wholesale Markets Review.

WHO DOES THIS APPLY TO? Relevant to those firms seeking clarification of the FCA's interpretation of the definition of "multilateral system".

WHEN DOES THIS APPLY? Likely to be in Q2 2023.

On 22 September 2022, the FCA published CP22/18: Guidance on the trading venue perimeter. Consultation closed on 25 November 2022. The FCA says that it expects to finalise the guidance and publish a policy statement in **Q2 2023**.

The consultation was part of the Wholesale Markets Review: the HM Treasury consultation in July 2021 had asked whether the trading venue perimeter should be clarified and, if so, whether this should be done through legislation or guidance. In the feedback to that consultation, the Treasury recognised that there was a need for greater clarity about the perimeter and recommended that the FCA should consult on guidance. CP22/18 sets out the regulator's proposals in relation to such guidance.

Currently, FCA guidance on multilateral systems is contained within the MAR Sourcebook but by the FCA's own admission this does not provide clarification on all the elements of the definition, nor does it apply that definition to arrangements or systems that are commonly used in the financial markets to support trading activities. The proposed guidance is therefore intended to

unpack the definition of "multilateral system" into its component parts and to apply the relevant concepts to specific types of arrangements.

New guidance on the definition of multilateral system

The new general guidance will sit in PERG 13 (Guidance on the scope of the UK provisions which implemented MiFID): this will provide the regulator's interpretation of each of the four elements of the definition of "multilateral system":

- *Element 1: Characteristics of a system of facility:*

  General purpose communications systems do not amount to trading systems or facilities, unless they are part of a facility performing functions intended to bring about transactions. Examples of activities that – taken by themselves – will constitute such general-purpose communications systems include acting as internet services providers, providing a telephone network, operating a website and providing chatroom facilities.

  However, where a system is designed as a general communications system but is part of a facility that is operated for the purpose of arranging transactions in financial instruments, that system would be regarded as a trading venue – that is, if the other elements of the definition of a multilateral system are met.

- *Element 2: Multiple third-party buying and selling trading interests*:

  The fact that, when two persons negotiate within a system, they do so between themselves does not mean that the system is bilateral rather than multilateral. What matters is whether the system, at the point of entry, is designed to enable one person to interact with others.

- *Element 3: Interaction within the system:*

  Interaction takes the form of an exchange of information relevant to the essential terms of a transaction in financial instruments (i.e. price, quantity, or subject matter). A system which enables such information to be inputted and then responded to, in that system, would allow interests to interact in the system in accordance with this element. Interactions can arise because the system matches trading interests within the system, or allows users to respond within the system to other users' trading interests (including by communicating in relation to, or negotiating or accepting the essential terms of, a transaction). Interaction does not require execution and settlement to be entered into within the system, provided it is with a view to the counterparties agreeing the contractual terms of the trade.

- *Element 4: Financial instruments*:

  The proposed guidance confirms that, because of the requirement for the interaction of multiple third-party buying and selling trading interest in the system to be in "financial

instruments", it does not include systems to trade foreign exchange spot contracts. This is consistent with the FCA's existing guidance on financial instruments as set out in PERG 13.4.

New Q&As on specific types of arrangements

To complement the guidance on the interpretation of the definition of multilateral system, the FCA is also proposing to introduce some Q&As on a number of particular arrangements where questions have frequently arisen as to whether they constitute such multilateral systems. These include:

- *Portfolio managers operating internal matching systems*: the proposed Q&A would clarify that the operation by a portfolio manager of an internal matching system, to execute, in the exercise of its discretion, trading interests relating to the portfolio of one of its clients does not constitute the operation of a multilateral system. (Further, the FCA does not consider that it is the purpose of FUND 1.4.3R or COLL 6.9.9R to prevent an external AIFM that is a full-scope UK AIFM or a UCITS management company from operating such an internal matching system in these circumstances. (FUND 1.4.3R and COLL 6.9.9R limit the activities that a full-scope UK AIFM and UCITS management company are permitted to do).) The rationale for this is that in each of these cases the manager is the only user of the system meaning that there is no interaction of multiple third-party trading interests in the system.

- *Blocking trades onto trading venues*: the proposed Q&A would indicate that where a firm operates a system for the purpose only of blocking trades onto a regulated trading venue consistent with the intentions of the parties to the underlying transaction to trade on a trading venue, such arrangements will not amount to the operation of a multilateral system. The example given is of large-in-scale trades arranged in accordance with the rules of the relevant venue.

- *Voice brokers*: voice broking may or may not comprise the operation of a multilateral system. Simply arranging or executing client order over the telephone, without more, does not constitute a multilateral system (though it may nonetheless amount to the MiFID investment services of reception and transmission of orders or execution of orders on behalf of clients). However, there are circumstance where voice broking might be caught. For example, a trading system or facility could take the form of a voice trading system or a hybrid system; the example given is of a platform where the clients' trading interests are broadcast to other users and the firm then engages in voice broking to enable negotiation between the parties. Voice broking might also be caught when it is provided in conjunction electronic order books, or other modes of execution.

- *Bulletin boards*: a series of proposed Q&As address bulletin boards which, in themselves, are not multilateral systems because, while trading interests can be posted on a bulletin board, trading interests are not able to interact. However, a firm would go beyond

simply operating a bulletin board if it (i) matches trading interests in the system, (ii) allows users to respond to other users' trading interests within the system or (iii) enables users to commit to, or enter into contracts within, the system.

Service companies

Beyond the proposed guidance on multilateral systems, the FCA also takes the opportunity to amend some outdated terminology in the definition of "service company".

Service companies are firms whose regulated activities are restricted to making arrangements with a view to transactions in investments (i.e. Article 25(2), Regulated Activities Order arranging) and agreeing to carry on that activity, and whose permissions are limited to certain non-retail client types and other requirements. Many service companies are technology companies which provide order routing, post-trade processing or other services to market participants, enabling such participants to deal in investments or arrange deals in investment among themselves. Service companies are subject to a lighter touch regulatory regime (COBS 18.10 provides that the only provisions of COBS that apply to such companies are COBS 4 (communications to clients, but only in relation to communicating or approving financial promotions), COBS 5.2 (e-commerce) and COBS 12.4 (research recommendations: required disclosures)).

The reason the FCA wants to update the Glossary definition is that, by way of hangover, it still refers to "old", pre-MiFID client categorisation terminology that used to be used by the regulator – i.e. "market counterparties" and "intermediate customers". While the proposed amendments would still retain this old terminology, they would also introduce current client categorisation terminology with respect to client limitation types. Therefore, the Part 4A permission of service companies will incorporate a limitation substantially to the effect that the firm carry on regulated activities with one or more of market counterparties, intermediate customers, professional clients or eligible counterparties (underlining represents the proposed additions).

While the FCA decided against making any changes to the specific requirements applicable to firms that operate multilateral trading facilities (MTFs) or organised trading facilities (OTFs) it did ask for comments on those regimes and whether the requirements operate as a barrier to entry for smaller firms – and it specifically queried whether the existing service company regime addresses this issue.

Interrelationship between new FCA guidance and ESMA Q&As

By way of reminder, before Brexit the FCA outlined its approach to EU non-legislative materials following the departure from the EU. Broadly, such non-legislative materials include Guidelines and Recommendations from each of the European Supervisory Authorities, as well as Q&As, as such materials stood on 31 December 2020 – firms are encouraged to continue to have regard to these materials, to the extent relevant. These include ESMA's Questions and Answers on MiFID

II and MiFIR market structures topics (available on the FCA website) which includes four Q&As that address the trading venue perimeter – specifically:

- Q&A 7: arranging transactions that are ultimately formalised on another trading venue.
- Q&A 10: characteristics of OTFs.
- Q&A 11: OTFs and voice trading.
- Q&A 12: Distinction between OTFs and MTFs.

The FCA acknowledges that the introduction of new FCA guidance in an area where there is specific guidance from ESMA to which firms should have regard could lead to confusion. Accordingly, although no specific rule or guidance amendments are suggested, FCA proposes that those specific ESMA Q&As dealing with the trading venue perimeter will not form part of the FCA's expectations following the finalisation of the proposed guidance set out in the consultation paper while it "will continue to have regard to all other Q&As in the ESMA market structures Q&As, in line with our approach to EU non-legislative materials". In other words, those four ESMA Q&As will be deemed to be "switched off", while the rest of the market structures Q&A will continue to be relevant. It is unclear whether the FCA will be doing any more than making this brief comment in the consultation paper: it does not appear to be suggesting any amendments or clarifications to its 2020 approach to EU non-legislative materials document. Arguably, it is not entirely satisfactory for firms to be required to continue having regard to the ESMA market structures Q&As, but at the same time to remember to disregard four specific questions on the trading venue perimeter. At the very least, it would help if the relevant Q&As to be disregarded were struck through in the "frozen" version of the Q&As available on the FCA website.

Legal uncertainty?

While the above ESMA Q&As are those which the FCA proposes to "switch off", the Financial Markets Law Committee (**FMLC**) is concerned about the legal uncertainty arising from another Q&A which the regulator has not addressed and to which, therefore, it will presumably continue to have regard. In its response to the FCA dated 1 December 2022, FMLC pointed to Q&A 25 in Section 3 of the ESMA markets structures Q&As, which addresses whether a firm needs to be authorised as an investment firm under MiFID II to provide direct electronic access (**DEA**) to an EU trading venue. The answer is that such authorisation *is* required, because Article 48(7) of MiFID II provides that trading venues should only permit a member or participant to provide DEA if they are investment firms authorised under that Directive or credit institutions authorised under the Credit Requirements Directive. "Therefore, non-EU firms (including non-EU firms licensed in an equivalent jurisdiction) or EU firms without a MiFID II licence are not allowed to provide DEA to their clients."

When first implementing MiFID II in the UK and later when "onshoring" the MiFID II/MiFIR regime into UK law, the UK has taken the position that third-country firms may provide DEA if the

activity is subject to the overseas persons exclusion (**OPE**) in Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and in Schedule, Part 1, paragraph 3C(a)(v) of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001. According to the FMLC, this appears to reflect a deliberate policy choice by the UK to allow the provision of DEA under the OPE.

Clearly the UK's position as regards the availability of the OPE relates to the position of a non-UK firm providing DEA in respect of a UK trading venue, whereas the ESMA Q&A rightly addresses the ability of firms to provide DEA to an *EU trading venue*. On that basis, the two positions are not inconsistent. However, FMLC's concern appears to be that, in expressly switching off only four ESMA Q&A in the ESMA markets structures Q&As, FCA might be seen as "endorsing" the specific Q&A on DEA as being applicable to a non-UK firm providing DEA to a UK trading venue. It suggests that the FCA should clarify that that Q&A does not form part of the regulator's supervisory expectation as regards the availability of the overseas persons exclusion.

FCA consultation: new core investment advice regime

WHAT IS THIS? Consultation on broadening access to financial advice for mainstream investments by introducing a new core investment advice regime.

WHO DOES THIS APPLY TO? Firms that give investment advice.

WHEN DOES THIS APPLY? 1 April 2024.

On 30 November 2022, the FCA published CP22/24: Broadening access to financial advice for mainstream investments. Consultation closes on **28 February 2023**. The FCA says that it expects to publish a policy statement with final rules and guidance in **spring 2023** with a view to firms being able to start offering the new core investment advice service from the beginning of **April 2024.**

The FCA's proposal, at the highest level, is to establish a new streamlined regulatory regime under which firms will be able to provide a level of financial advice proportionate to a consumer who has straightforward needs and who holds excess cash to invest that cash within a stocks and shares ISA wrapper. No changes will be made to the perimeter in terms of the regulated activity of advising on investments (which in any event would have to be made by HM Treasury) but within that regulated activity the FCA will delineate a "sub-regime". In other words, core investment advice would involve a narrower scope than "holistic" financial advice.

Core investment advice – what is it?

A new definition of "core investment advice" will be set out in the FCA Glossary. The *effect* of the definition will be that:

- Advice may only be given on investments held within a new stocks and shares ISA wrapper (**S&S ISA**) (including ongoing personal recommendations where that advice is part of an arrangement entered into at the time the new ISA is opened):
    - other types of ISA will be expressly excluded, e.g. innovative finance ISAs, junior ISAs, lifetime ISAs, maxi-ISAs, mini-ISAs, group ISAs;
    - the FCA proposes to further narrow the regime so that advice may only be given on a *sub-set* of investment products that can be held within a S&S ISA (The Individual Savings Account Regulations 1998 (the **ISA Regulations**) sets out a list of qualifying investments for S&S ISAs); and
    - high-risk investments will be excluded: the proposed definition will specify that the relevant investment cannot be a restricted mass market investment (a non-readily realisable security, a P2P agreement or a P2P portfolio), a non-mass market investment (a non-mainstream pooled investment or a speculative illiquid security) or an insurance-based investment product or other life policy.
- Advice may only relate to investments up to the value of the annual ISA subscription limit set by HM Treasury in Section 4ZA(1) of the ISA Regulations) (i.e., currently, £20,000):
    - transfers of ISA subscriptions from any year where that ISA subscription involves a stocks and shares component will be excluded; and
    - cash ISA transfers will be permitted up to the annual ISA subscription limit – in other words, transfers of ISA subscriptions consisting of a cash component will be excluded where the amount to be transferred exceeds the amount specified in Section 4ZA(1) of the ISA Regulations.

When can core investment advice be given?

A firm may provide core investment advice where *all* of the following criteria are satisfied:

- the firm (or in the context of an AR adviser, the principal firm) has Part 4A permission to advise on investments;
- the proposed advice service meets the scope set out in the definition of core investment advice (see above);
- the individual adviser is qualified to give holistic financial advice (QCF level 4 or above) or is qualified up to a specified level to provide core investment advice – see *Training and Competence* below;
- the FCA has been notified of the firm's intention to provide core investment advice; and
- requirements under the Senior Managers and Certification Regime (**SMCR**) are met (or, in the case of an individual adviser within an appointed representative, requirements under the Approved Persons Regime (**APR**) are met) – see *SMCR and APR* below.

Suitability – no new rules but guidance on how to streamline the process

At the outset it is important to note that there will be no amendments to the existing COBS 9A requirements for the assessment of suitability (applicable to MiFID business and insurance-based investment products). However, the FCA will be introducing new non-Handbook guidance to indicate how firms should undertake a streamlined fact-find and suitability assessment in light of the narrower scope and complexity of advice – a draft of this is set out in Appendix 2 to the consultation paper.

Since any firm that offers core investment advice is likely to be a manufacturer and distributor of that service, it will have to comply with the Consumer Duty and specifically PRIN 2A.3.4R relating to the product approval process – so firms will need to identify the relevant target market. The Product Intervention and Product Governance sourcebook (**PROD**) will also be relevant.

Training and competence – relaxed qualification requirements

The FCA proposes to create a new activity for core investment advice in its Training & Competence sourcebook – TC Activity 4A. Individual advisers undertaking the new core investment advice activity will only be required to pass the *Financial Services, Regulation and Ethics* and *Investment Principles and Risk* modules of the QCF Level 4 qualification that retail investment advisers need to take.

Fees and charges – payment in instalments will be allowed

A new rule will be introduced allowing firms to accept payment for core investment advice in instalments, even where the advice given is transactional and there is no ongoing service or ongoing subscription to an S&S ISA. In such a case, the firm would have to give an appropriate disclosure about the charging structure.

SMCR and APR

Financial advisers who are already certified by their firm to provide holistic financial advice will not require re-certification in order to offer core investment advice – they will be subject to the annual reassessment of fitness and propriety as now.

New advisers who will be offering core investment advice only will need to be assessed as fit and proper in accordance with the existing rules (which will not change). There will be a transitional rule meaning that, where a firm certifies a new adviser for core investment advice, it will have a year from implementation in which to report the certification to the FCA via Connect.

The FCA will be applying its existing rules and guidance in relation to the APR as regards any appointed representatives offering core investment advice only.

3 ESG AND SUSTAINABLE FINANCE

Introduction

The EU Taxonomy Regulation, with its highly detailed technical screening criteria, forms the benchmark against which the UK will be hoping to develop its own taxonomy, the UK Green Taxonomy. But it hasn't been without its problems – the inclusion of nuclear and gas activities as potentially Taxonomy-aligned activities was highly controversial. There has also been a plethora of FAQs from the Commission – some consolidation would be welcome. The four remaining environmental objectives are still awaited. See the round-up of developments under the EU Taxonomy below. Meanwhile the development of an EU Social Taxonomy proceeds at – relatively speaking – a snail's pace.

While the EU Sustainable Finance Disclosure Regulation (**EU SFDR**) has been in force since March 2021, and the periodic disclosure reporting requirements began to apply on 1 January 2022, the detailed RTS requirements – which included the templates on which firms are required to report – were repeatedly postponed until they finally came into force on 1 January 2023. A Corrigendum of the RTS was published on 27 December 2022 and we are still awaiting some further amendments to give effect to the inclusion of nuclear and gas activities as potentially Taxonomy-aligned activities. And that is not the end of the story on the RTS under EU SFDR. The ESAs have been mandated to draft further amendments to the EU SFDR RTS specifically relating to the indicators for PAIs and financial product disclosures. The ESAs wrote to the Commission in November saying that they would not be able to meet the original deadline and that delivery of the draft RTS would be pushed back to November 2023. Otherwise, in December 2022, Mairead McGuinness, European Commissioner for Financial Services, Financial Stability and Capital Markets Union indicated that the Commission is currently reviewing the EU SFDR and will be publishing a consultation early in 2023. It will also be publishing a set of Q&As on the EU SFDR, also early in 2023. See the EU SFDR round-up below.

Elsewhere, ESMA has consulted on restricting the use of ESG or sustainability-related terms in the names given to funds while the ESAs have called for evidence on greenwashing. (Greenwashing is a growing concern not only for the regulators in the UK and EU: IOSCO has recently issued a call for action to promote good practices to counter greenwashing risks, with sections dedicated to asset managers and ESG rating and data providers.) There are two separate, but connected, initiatives that deal with corporate sustainability. The Corporate Sustainability Reporting Directive (**EU CSRD**) has now been published in the Official Journal and will require certain large and listed companies to make sustainability reports. Implementation is to be staggered: public interest entities that are already subject to the Non-Financial Reporting Directive will have to start reporting in 2024. Non-EU entities will have until 2028. Under the Corporate Sustainability Due Diligence Directive (**EU CS3D**) – which is intended to complement the EU CSRD – large companies, including third country companies with significant operations in

the EU, will be required to apply due diligence to their supply chains to avoid adverse impacts on the environment and human rights. This isn't finalised yet. See the round-up of other EU sustainable finance developments below.

In comparison to the EU, the development of the UK's sustainable finance regime proceeds more sedately. The UK is keen to learn from the EU's mistakes and some of the problems it has encountered. The FCA ESG Rules – which mandate TCFD-aligned disclosure requirements for certain asset managers and asset owners have been in force for the biggest asset managers from 1 January 2022 and came into force for small asset managers (except those who are exempt) on 1 January 2023 (see the brief round-up of other UK sustainable finance developments below). The FCA has now consulted on a UK Sustainable Disclosure Requirements (SDR) regime (**UK SDR**) and the introduction of a set of investment labels. The rules will essentially "overlay" the existing TCFD-derived rules in the ESG sourcebook. To an extent this represents the UK's answer to the EU SFDR, though the introduction of three distinct investment labels is quite different. The first disclosures would come into force on 30 June 2024 at the earliest – though a more general anti-greenwashing rule that will apply to all firms will come into force on 30 June 2023. At the moment, the FCA says, "overseas products" are out of scope of the requirements, although it is not clear that is quite the effect of the draft rules as regards unauthorised AIFs that are non-UK funds managed by UK AIFMs. In any event, it will be question of "watching this space" to see how and to what extent the requirements will be extended to institutional non-UK funds. See UK Sustainable Disclosure Requirements (SDR) Regime and labelling below. Lagging behind is the UK Green Taxonomy and the development of the associated technical screening criteria – there is no clear indication of when the Taxonomy is likely to come into force (see UK Green Taxonomy below).

Travers Smith ESG timeline, ESG App and Sustainability Insights

Our Travers Smith ESG timeline is an important resource for corporates and alternative asset managers seeking to manage ESG compliance. The timeline sets out recent and expected UK and EU legal and regulatory developments in the ESG sphere.

The timeline is supported by regular updates and lengthier guidance and analyses of ESG-related developments which can be found on the ESG pages of the Travers Smith website.

At the end of last year, we launched an app to help clients understand their reporting obligations under the new UK requirements to report climate risks and opportunities using TCFD recommendations and under the EU SFDR. The app can be accessed here.

You may also be interested in reading or listening to Sustainability Insights, our regular series of briefings providing the latest thinking from our team of experts on sustainable finance topics for the alternative asset management industry.

EU Taxonomy – a round-up

WHAT IS THIS? A round-up of developments in relation to the EU Taxonomy Regulation.

WHO DOES THIS APPLY TO? Most provisions apply to EU portfolio managers, investment advisers, AIFMs and UCITS management companies. However, some provisions also apply to non-EU firms marketing or distributing financial products in the EU and/or certain large or listed companies. Over time, the Taxonomy will become increasingly relevant to other EU issuers and stakeholders, such as smaller EU companies, as it is given life by other EU law, such as the EU Corporate Sustainability Reporting Directive.

WHEN DOES THIS APPLY? The EU Taxonomy Regulation is already in force as is the Climate Delegated Regulation (1 January 2023). The Complementary Climate Delegated Act (introducing nuclear and gas as Taxonomy-aligned activities) started applying on 1 January 2023. See our ESG timeline for other dates and details.

The EU Taxonomy Regulation

By way of reminder, Regulation (EU) 2020/852, the EU Taxonomy Regulation, introduced an EU-wide taxonomy or classification framework for determining whether, and to what extent, certain economic activities can be considered environmentally sustainable. Environmental sustainability is one element of sustainability under EU SFDR and therefore the two pieces of legislation are effectively connected.

EU Taxonomy: the six environmental objectives

1	**Climate change mitigation**	1 Jan 2022
2	**Climate change adaptation**	1 Jan 2022
3	Sustainable use and protection of water and marine sources	1 Jan 2023
4	Transition to a circular economy	1 Jan 2023
5	Pollution prevention and control	1 Jan 2023
6	Protection and restoration of biodiversity and ecosystems	1 Jan 2023

The part of the EU Taxonomy Regulation in respect of the first two environmental objectives – climate change mitigation and climate change adaptation – took effect on 1 January 2022. The

remaining four environmental objectives technically came into effect on 1 January 2023, but as we outline below, the technical screening criteria in respect of these are not yet in force.

The EU Taxonomy Compass, maintained by the European Commission, is a useful tool for navigating – and keeping up-to-speed with – the requirements of the EU Taxonomy. Among other things the Compass makes it easier to integrate the requirements into business databases and other IT systems – it can be downloaded into MS excel (slsx) or JSON format.

The EU Taxonomy Climate Delegated Regulation

The EU Taxonomy Climate Delegated Regulation supplements the EU Taxonomy Regulation and specifies technical screening criteria for determining the conditions under which an economic activity contributes substantially to climate adaptation and/or climate mitigation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. The Annex sets out the highly detailed technical screening criteria for a large number of (predominantly industrial) activities. The EU Taxonomy Climate Delegated Regulation started applying on 1 January 2022.

The EU Taxonomy Complementary Climate Delegated Act – nuclear and gas

The ink had hardly dried on the EU Taxonomy Climate Delegated Regulation (see above) when further changes were afoot. On the same date that the EU Taxonomy Climate Delegated Regulation started applying – 1 January 2022 – the European Commission confirmed that it had already begun consultations with the Member States Expert Group on Sustainable Finance and the Platform on Sustainable Finance on a draft text of a complementary act that would extend to cover certain gas and nuclear activities.

This was a controversial move and the act – the, so-called (and jawbreaking) Taxonomy Complementary Climate Delegated Act – had a bumpy ride through the EU legislative process. At one point it looked possible that the legislation would be voted down. However, it eventually made it through the co-decision procedure and, on 15 July 2022, the Taxonomy Complementary Climate Delegated Act (Commission Delegated Regulation (EU) 2022/1214) was published in the Official Journal. It started applying from **1 January 2023**.

In brief, the Taxonomy Complementary Climate Delegated Act:

- **Introduces additional economic activities from the energy sector into the EU Taxonomy** – by setting out strict conditions subject to which certain nuclear and gas activities can be added as "transitional activities" over and above those already covered by the first Delegated Act on Climate Mitigation and Adaptation. Those conditions for the inclusion of natural gas and nuclear activities include the following (more specific additional conditions apply):
    - For both, that they contribute to the transition to climate neutrality.
    - For nuclear, that it fulfils nuclear and environmental safety requirements.

- For natural gas, that it contributes to the transition from coal to renewables.

Annex 1 to the Regulation sets out the detailed technical screening criteria for the specific nuclear and natural gas activities which make a substantial contribution to climate change mitigation and "do no significant harm" (**DNSH**). Annex 2 sets out the detailed technical screening criteria, organised by the same activities, which make a substantial contribution to climate change adaptation and DNSH.

- **Introduces specific disclosure requirements for businesses related to their activities in the gas and nuclear energy sectors** – the Taxonomy Complementary Climate Delegated Act also amends Commission Delegated Regulation (EU) 2021/2178 (the **Article 8 Delegated Regulation**) by supplementing Article 8 of the EU Taxonomy Regulation to require large listed non-financial and financial companies to disclose the proportion of their activities linked to natural gas and nuclear energy. Annex 3 contains the standard templates for these activities, for each applicable key performance indicator.

The four remaining environmental objectives under Article 9, EU Taxonomy Regulation and the Platform on Sustainable Finance

As mentioned above, the four remaining environmental objectives under Article 9 of the EU Taxonomy Regulation – the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the prevent and restoration of biodiversity and ecosystems – came into effect on 1 January 2023.

However, as with the first two climate objectives, disclosing against the remaining environmental objectives is dependent on the existence of detailed technical screening criteria for determining the conditions under which an economic activity contributes substantially to the relevant objective and for determining whether that economic activity causes no significant harm to any of the other environmental objectives.

In March 2022, the Platform on Sustainable Finance (**PSF**) had published a report with its recommendations on such technical screening criteria, together with an Annex setting out the proposed technical screening criteria themselves.

On 28 November 2022, the Technical Working Group of the PSF published a report with supplementary advice on methodology and technical screening criteria for the climate and environmental objectives of the EU Taxonomy. This:

- Supplements the Platform's March report and outlines the work undertaken since then.
- Sets out a framework methodology to describe so-called "enabling activities", as defined in Article 16 EU Taxonomy Regulation (i.e. broadly speaking, activities that qualify as contributing substantially to one or more of the Article 9 environmental objectives by directly enabling other activities to make a substantial contribution to one or more of

those objectives, provided they do not lead to a "lock-in" of assets that undermine long-term environmental goals and they have a substantial positive environmental impact).

- Provides recommendations to the European Commission to consider in its further work on the EU Taxonomy.
- Includes, in Part B of the report, additional technical screening criteria on the four remaining environmental objectives that the PSF has developed since March 2022.

The Article 8 Delegated Regulation – environmental disclosures in non-financial statements

Commission Delegated Regulation (EU) 2021/2178, (the **Article 8 Delegated Regulation**) which supplements Article 8 of the EU Taxonomy Regulation, and which specifies the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU (the **Accounting Directive**, as amended by Directive 2014/95/EU (the **Non-Financial Reporting Directive**)), has applied from 1 January 2022, subject to phasing in of the requirements.

Article 8 of the EU Taxonomy Regulation requires undertakings subject to Articles 19a or 29a of the NFRD ("large public interest entities") to include, in their non-financial statements, information on how and to what extent their activities are associated with environmentally sustainable economic activities. It requires the European Commission to adopt a delegated act to supplement this requirement.

"Large public interest entities" is a term of convenience to describe those undertakings that are subject to Articles 19a or 29a of Directive 2013/34/EU (the **Accounting Directive**, as amended by Directive 2014/95/EU (the **Non-Financial Reporting Directive**)). Broadly speaking, this means:

- "large undertakings" as defined in Article 3(4) of the Accounting Directive – i.e. undertakings which on their balance sheets show at least two of the following criteria: balance sheet total of EUR 20,000,000 and net turnover of EUR 40,000,000 and more than 250 employees (though this third criterion is effectively overridden by the third limb below);
- which are "public-interest entities" as defined in Article 2(1) of that Directive – i.e. broadly, undertakings which are governed by the law of an EU member state and whose securities are admitted to trading on an EU regulated market, credit institutions and insurance undertakings; and
- with more than 500 employees on average on a consolidated basis during the financial year.

Accordingly, the Article 8 Delegated Regulation specifies the content and presentation of information to be disclosed by such undertakings and sets out common rules relating to key performance indicators (**KPIs**). The information to be disclosed differs depending on what type of NFRD-subject undertaking it is. The Article 8 Delegated Regulation distinguishes between financial and non-financial undertakings. Financial undertakings include asset managers (AIFMs,

UCITS management companies, credit institutions, MiFID investment firms and insurance companies). Non-financial undertakings are undertakings that are also subject to the Article 8 disclosure obligation, but which are not financial undertakings as defined. This broadly captures certain large, listed entities.

In terms of the requirements that had already started applying under the Article 8 Delegated Regulation last year:

- *1 January 2022 to 31 December 2022*: non-financial undertakings were required to disclose the proportion of *Taxonomy-eligible* and *Taxonomy non-eligible* economic activities in their total turnover, capital and operational expenditure, together with certain qualitative information.
- *1 January 2022 to 31 December 2023*: financial undertakings are required to disclose the proportion of *Taxonomy-eligible* and *Taxonomy non-eligible* economic activities in their total assets, together with certain quantitative and qualitative information.

> It should be noted that "Taxonomy-eligible" does not mean that the economic activity is "green" or Taxonomy-*aligned* as such, just that it is an activity that is described in the EU Taxonomy Climate Delegated Regulation. An economic activity which is described in the EU Taxonomy Climate Delegated Regulation is therefore eligible irrespective of whether it meets any or all of the technical screening criteria laid down in that Regulation. In other words, the fact that an economic activity is Taxonomy-eligible does not give any indication of the environmental performance and sustainability of that activity. By contrast, Taxonomy-alignment goes further: an activity which is Taxonomy-aligned will be compliant with the technical screening criteria, the "do no significant harm" (**DNSH**) criteria and the minimum safeguards.

In terms of the other requirements under the Article 8 Delegated Regulation, the application is as follows:

- *1 January 2023*: non-financial undertakings are required to disclose KPIs and other specified information.
- *1 January 2024*: financial undertakings are required to disclose KPIs and other specified information.

While credit institutions are financial undertakings are therefore subject to the above timelines, a couple of very specific disclosures to be made by them (KPIs for fees and commission income arising on services other than lending and deduction of the trading portfolio from the green asset ratio (**GAR**)) do not apply until 1 January 2026.

European Commission further FAQs on sustainability disclosures under Article 8 of EU Taxonomy Regulation

On 6 October 2022, a Commission Notice setting out frequently asked questions (FAQs) to support disclosures under Article 8 of the EU Taxonomy Regulation was published in the Official Journal. This complements the 22 FAQs that the Commission had previously published on 20 December 2021 (updated January 2022) on How financial and non-financial undertakings should report Taxonomy-eligible economic activities and assets in accordance with the Article 8 Delegated Regulation.

As outlined above, the Article 8 Delegated Regulation requires "large public interest entities" to include additional information in their non-financial statements on how and to what extent their activities are associated with environmentally sustainability economic activities that are aligned with the EU Taxonomy Regulation. As mentioned in the previous item, "large public interest entities" is a term of convenience to describe those undertakings that are subject to Articles 19a or 29a of Directive 2013/34/EU (the **Accounting Directive**, as amended by Directive 2014/95/EU (the **Non-Financial Reporting Directive**)) – see The Article 8 Delegated Regulation – environmental disclosures in non-financial statements above for more details.

The FAQs had originally been published in draft form in February 2022. They aim to clarify the requirements of the Article 8 Delegated Regulation (see above).

European Commission Notices under EU Taxonomy legislation

On 20 December 2022, the European Commission published two further draft Commission Notices under the EU Taxonomy Regulation and the EU Taxonomy Article 8 Delegated Regulation containing frequently asked questions:

- a Draft Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Climate Delegated Act establishing technical screening criteria for economic activities that contribute substantially to climate change mitigation or climate change mitigation and do no significant harm to other environmental objectives. The FAQs are set out in three sections: horizontal questions, sector specific questions on technical screening criteria (e.g. in relation to forestry, manufacturing, energy, water supply etc) and questions on recurring DNSH criteria. The three appendices set out generic criteria for: DNSH to climate change adaptation; DNSH to pollution prevention and control regarding the use of chemicals; and DNSH to protection and restoration of biodiversity and ecosystems. The Commission says this Notice complements previous guidance set out in:
    - the 20 December 2021 FAQs: How should financial and non-financial undertakings report Taxonomy-eligible economic activities and assets in accordance with the Article 8 Delegated Regulation; and
    - the 6 October 2022 Commission Notice on the interpretation of certain legal provisions of the Disclosures Delegated Act under Article 8 of the EU Taxonomy Regulation on the reporting of eligible economic activities and assets (see previous item above).

- a Draft Commission Notice on the interpretation and implementation of certain legal provisions of the Disclosures Delegated Act under Article 8 of the EU Taxonomy Regulation on the reporting of Taxonomy-eligible and Taxonomy-aligned economic activities and assets. It should be noted that the Commission has already published three sets of guidance on the content of the Article 8 Delegated Regulation: the 20 December 2021 FAQs and the 6 October 2022 Commission Notice referred to above, and a Commission staff document FAQ: What is the EU Taxonomy Article 8 delegated act and how will it work in practice?

Both Draft Commission Notices were approved in principle by the European Commission on 19 December 2022; they will be formally adopted as and when they have been translated into all the official languages of the European Union.

EU Platform on Sustainable Finance – Final Report on Minimum Safeguards

On 12 October 2022, the EU Platform on Sustainable Finance (the **Platform**) published, and delivered to the European Commission, its Final Report on Minimum Safeguards. This followed the Platform's draft report which had been published in July 2022 (we published a briefing on this at the time: Do we finally have some clarity over "minimum safeguards" in sustainable finance?).

The concept of "minimum safeguards" appears in various EU ESG rules and is concerned with the negative impacts of economic activities. When exploring the links between minimum safeguards and EU legislation, the Final Report focuses on the existing EU SFDR, the upcoming EU Corporate Sustainability Reporting Directive (**EU CSRD**) and the upcoming Corporate Sustainability Due Diligence Directive (**EU CS3D**). See Other EU Sustainable finance developments – a round up, Corporate Sustainability: EU CSRD and EU CS3D below.

By way of background, under Article 3(c) of the EU Taxonomy Regulation, an economic activity will qualify as environmentally sustainable where it is "carried out in compliance with the minimum safeguards set out in Article 18". Article 18, EU Taxonomy Regulation states that these minimum safeguards shall be "procedures implemented by an undertaking that is carrying out an economic activity to ensure the alignment with the OECD Guidelines for Multilateral Enterprises (**OECD Guidelines**) and the UN Guiding Principles on Business and Human Rights (**UNGP**), including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights".

Article 18(2) EU Taxonomy Regulation establishes a direct link between the minimum safeguards referred to in Article 18(1) EU Taxonomy Regulation and EU SFDR. While neither the EU Taxonomy nor the EU CSRD require *adherence* to the standards referred to above (they both relate to *disclosures*), EU CS3D will eventually require in-scope companies to comply with national implementing rules aligned with international standards on human rights and labour laws.

By way of analysing the standards referred to in Article 18, EU Taxonomy Regulation, the Final Report identifies four core topics through which compliance with minimum safeguards should be identified:

- Human rights, including workers' rights.
- Bribery/corruption.
- Taxation.
- Fair competition.

The advice on each of these four topics is aligned with the standards referred to in Article 18, EU Taxonomy Regulation (see quoted extract above), as well as the upcoming measures in EU CSRD and EU CS3D.

Although there is a lot of detail in the Final Report, and its findings and advice may need revision in the light of the final versions of EU CSRD and EU CS3D, the Platform's main recommendations are for the European Commission to treat the following criteria as evidence of *non-compliance* with minimum safeguards:

- Inadequate or non-existent corporate due diligence processes on human rights (including labour rights, bribery, taxation and fair competition).
- "Final liability" of companies on any of the above matters (the July 2022 draft report had suggested a "final conviction … in court"). The Final Report suggests that the adequacy (or otherwise) of a corporate due diligence process should be measured via the disclosures under EU CSRD and EU CS3D where applicable.
- The lack of collaboration with a national contact point (NCP)(under the OECD Responsible Business Conduct Guidelines for Multinational Enterprises), and an assessment of non-compliance with the OECD Guidelines by an OECD NCP.
- Failing to respond to allegations by the Business and Human Rights Resource Centre within three months.

The Final Report also sets out advice on some special cases: project financing, SME financing, green bonds and how to assess sub-sovereign compliance with minimum standards.

EU Platform on Sustainable Finance – report on data and usability of EU Taxonomy

There is no doubt that the EU Taxonomy, with its highly detailed technical screening criteria, is a major achievement, placing the EU at the vanguard when it comes to sustainable finance identification, data collection and reporting. However, being largely first to "market" with a comprehensive regime means having to confront considerable complexities when trying to apply it in the real world: significant practical challenges in the usability of that legislative

framework have emerged, based on data that the EU Platform on Sustainable Finance (the **Platform**) has collected and analysed.

On 12 October 2022, the Platform published its detailed Report on Data and Usability, in furtherance of its mandate to report on the usability of the EU Taxonomy and to facilitate Taxonomy reporting. Under that mandate it is required to advise in four main areas:

- Data quality, availability and the extent to which the market is prepared to meet the disclosure obligations under EU Taxonomy Regulation, particularly under Article 8.
- The possible role of sustainability accounting and reporting (financial and non-financial) standards in supporting the application of the technical screening criteria.
- The usability of the criteria.
- The evaluation and development of sustainable finance policy issues.

In outline, the Platform's recommendations in the Usability Report cover the following main proposed actions:

- Proposed changes to Level 1 legislation or Level 2 guidance on EU Taxonomy reporting (as part of the European Commission's review of the Article 8 Delegated Regulation by 30 June 2024 as required by Article 9 of that Regulation (the **June 2024 review**)).
- Supplementary guidance from the European Commission to user groups.
- Supervisory guidance from the European Supervisory Authorities.
- The development of consistent policy across the sustainable finance framework.
- Taxonomy usability.

In terms of Taxonomy usability, the Platform has identified the following problems or needs:

- Misalignment between the various sustainable finance reporting requirements and inconsistent definitions of the same terms (such as "sustainable investment" and "do no significant harm").
- Sequencing issues across the reporting framework – i.e. having data available to financial institutions to enable them to satisfy the reporting obligations that apply to them.
- Disproportionate regulatory reporting requirements or "regulatory overload" across the various sectors subject to reporting requirements, with a view to ensuring that such requirements are evenly distributed and proportional.
- A need for consistent and clear interpretation of the reporting requirements applying to all user groups – i.e. in terms of what needs to be reported, how and by when.

- The need to plug any residual regulatory gaps and address any regulatory barriers to using the EU Taxonomy and ensuring that data is available and accessible.

In the light of the above broad groupings, a detailed summary of the Platform's specific recommendations is set out in Table 2 of the Executive Summary. Each recommendation has been allocated a priority rating of high, medium or low based on how urgently the Platform thinks the issue needs addressing (in light of the already implemented and upcoming sustainable finance reporting obligations). A high priority item is one that requires the urgent intervention of the European Commission or the European Supervisory Authorities (**ESAs**) in order to facilitate short-term implementation. A medium priority item relates to the requirement for legislative amendments, including considerations for the June 2024 review. Lower priority items will require further work from the European Commission or the ESAs – or the Platform itself – before implementation can proceed. The report does not address the application of the EU Taxonomy to small and medium-sized enterprises (**SMEs**) since these will be subject to a separate Platform report on data and usability.

The "high priority" items identified by the Platform include the following:

- Non-financial undertakings – Taxonomy reporting the Article 8 Delegated Act:
    - Supplementary FAQs for Article 8 reporting.
    - Level 3 implementation guidelines from the ESAs.
    - European Commission updates of the reporting Annexes.
- Financial undertakings – Taxonomy reporting under the Article 8 Delegated Act:
    - Supplementary FAQs for Article 8 reporting.
    - Level 3 implementation guidelines from the ESAs.
    - Amendments to allow for the use of "equivalent information" (as well as estimates).
    - The inclusion of all use-of-proceeds financial instruments (e.g. loans, bonds) in all numerators and denominators throughout all relevant EU legislation.
    - European Commission development of a common approach to defining numerators and denominators across Taxonomy reporting obligations.
- FMPs Taxonomy reporting under Article 5 and 6, EU Taxonomy Regulation:
    - Review on the usability of DNSH criteria and supplementary guidance on the use of such criteria internationally.
- Climate Delegated Act:

- European Commission application of clear and consistent numbering and naming conventions to economic activities and clarification of imprecise language in the TSC – seeking greater alignment between different pieces of legislation (such as the EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive (**CSRD**)).

- As regards the adoption of the remaining four environmental objectives, the Platform recommends that the European Commission should continue to provide at least 12-months from first setting any new technical screening criteria (**TSC**) to the date on which reporting must be effective, in order to allow companies to adapt.

- The Platform recommends that the European Commission should consider providing detailed, technical guidance on how emerging technologies and venture capital can consider alignment with the Climate Delegated Act (including under data-driven solutions for greenhouse gas emissions reductions; professional, scientific and technical activities; and manufacture of e.g. renewable energy technologies and low carbon technologies).

- EU Sustainable Finance Disclosure Regulation (**EU SFDR**):

  - Greater alignment by the European Commission between EU SFDR and the EU Taxonomy Regulation (including, for instance, by aligning social and governance PAIs and minimum safeguards of the latter and including a short list of "always principally adverse" activities until such time (if at all) the EU Taxonomy includes such activities.

  - Clarification by the European Commission to ensure a clear distinction between environmental DNSH under the EU Taxonomy and DNSH under EU SFDR, which is captured through PAIs.

  - Alignment by the European Commission of the measurement of PAI indicators with the measurement of DNSH criteria under the EU Taxonomy.

  - Using the guidance on the application of minimum safeguards in the context of the EU Taxonomy (see above) in the context of minimum safeguards under EU SFDR.

  - Amendment of the EU SFDR RTS to replace UN Global Compact with UN Guiding Principles of Business and Human Rights – aligning ESRS and PAI social indicators with the Taxonomy's minimum safeguards by referring to the UN Guiding Principles for Business and Human Rights (instead of UN Global Compact principles).

- Development of a simplified and easy-to-understand pre-contractual template, tailored to the sustainability preferences.

Finally, the Report sets out a number of recommendations for future work to be carried out by the Platform – in addition to work that is already ongoing: this includes areas where it considers that further advice should be given in the near future and areas where, if the European Commission asks, the Platform could provide further advice.

EU Sustainable Finance Disclosure Regulation – a round-up

WHAT IS THIS? The regulatory technical standards supplementing EU SFDR setting out details.

WHO DOES THIS APPLY TO? Most provisions apply to EU portfolio managers, investment advisers, AIFMs and UCITS management companies. However, some provisions also apply to non-EU firms marketing or distributing financial products in the EU.

WHEN DOES THIS APPLY? The regulatory technical standards finally came into force on 1 January 2023.

EU Sustainable Finance Disclosure Regulation

The EU Sustainable Finance Disclosure Regulation (**EU SFDR**) came into force in March 2021. It requires in-scope firms to make disclosures on the integration of "sustainability risks" in their investment decision-making, the likely impact of such risks on investment returns and information on "principal adverse impacts" (**PAIs**). EU SFDR applies to portfolio managers, alternative investment fund managers (AIFMs), UCITS management companies, EuVECA managers and EuSEF managers, as well as investment advisers. Importantly, although it principally applies to EU firms, some significant obligations are also applicable to non-EU firms marketing or distributing financial products in the EU.

The "Level 1" periodic disclosure reporting requirements began to apply on 1 January 2022 – but, as outlined below, the detailed RTS requirements were postponed to 1 January 2023.

EU SFDR regulatory technical standards

The in-force RTS

As we have previously reported, unfortunately, despite EU SFDR having been in force since March 2021, the all-important regulatory technical standards setting out details regarding the content and presentation of the required disclosures have been subject to repeated postponements. The relevant regulation, Commission Delegated Regulation (EU) 2022/1288 (**EU SFDR RTS**) came into force on **1 January 2023** (the link is to the Corrigendum published on 27 December 2022 which replaced the whole of the text that had originally been published in the Official Journal on 25 July 2022).

By way of reminder, the EU SFDR RTS include provisions on:

- Details on the content and presentation of the information on "do no significant harm" (**DNSH**). DNSH is the principle that, to be a sustainable investment it must not only contribute to an environmental (or social) objective but must also *not* significantly harm any of the other environmental (or social) objectives.

- Details of the content, methodologies, and presentation of information in respect of certain sustainability indicators (the mandatory principal adverse impact (**PAI**) indicators that certain firms will need to consider and report upon) – annexed to the RTS is the prescribed-form template for the statement for presenting key performance indicators under the PAI regime. Principal adverse impact indicators are essentially a mandatory list of sustainability factors or indicators that firms must take into account and disclose against, which should – in theory at least – allow investors insight into the adverse impacts (or "negative externalities") of the products they decide to invest in. The list broadly falls into two "halves": climate and other environment-related indicators and indicators for social and employee, respect for human rights, anti-corruption and anti-bribery matters. Specific mandatory PAI indicators include: greenhouse gas emissions (such as GHG emissions, scope 1, 2, 3 and total; carbon footprint; GHG intensity of investee companies; and exposure to companies active in the fossil fuel sector); violations of UN Global Compact principles and OECD Guidelines for Multinational Enterprises, board gender diversity, gender pay gap and exposure to controversial weapons.

- Details of the content and presentation of the pre-contractual information to be disclosed under Articles 8 and 9 EU SFDR – annexed to the RTS are the prescribed-form templates for:

    - Pre-contractual disclosures for Article 8 products (i.e. those which promote environmental or social characteristics).

    - Pre-contractual disclosures for Article 9 products (i.e. those which invest exclusively in "sustainable investments" within the meaning of Article 2(17) EU SFDR).

- Details of the content and presentation of website disclosures under Article 10 EU SFDR.

- Details of the content and presentation of the information disclosed in periodic reports under Article 11 EU SFDR – annexed to the RTS are the prescribed-form templates for:

    - Annual reports for Article 8 products.

    - Annual reports for Article 9 products.

Amendments to the EU SFDR RTS – nuclear and fossil gas

However, that was not the end of the long-running saga of the EU SFDR RTS. As mentioned above, the Taxonomy Complementary Climate Delegated Act – which controversially added nuclear and fossil gas activities to the list of economic activities falling under the EU Taxonomy and which had a bumpy ride through the EU legislative process – was published in the Official Journal on 15 July 2022 and came into force on 1 January 2023.

In the light of extension to include Taxonomy-aligned screening criteria for certain nuclear and gas activities and specific disclosures requirements for businesses related to their activities in those sectors, further tweaks were needed to the EU SFDR RTS. On 30 September 2022, the European Supervisory Authorities (**ESAs**) published their Final Report on draft regulatory technical standards, which amend the existing EU SFDR RTS, including the prescribed-form templates (draft amending RTS). The amendments, which had been requested by the European Commission to ensure that investors receive information reflecting provisions set out in the Taxonomy Complementary Climate Delegated Act, relate specifically to disclosures about the exposure of financial products to investments in fossil gas and nuclear energy activities.

Broadly, the changes set out in the draft amending RTS address:

- Chapter II of the EU SFDR RTS on pre-contractual disclosures – by requiring a separate graphical representation of the proportion of the aggregated investments in nuclear and fossil gas activities identified as being environmentally sustainable activities in accordance with the additional climate technical screening criteria inserted into the EU Taxonomy Climate Delegated Regulation by the Taxonomy Complementary Climate Delegated Act (**additional climate technical screening criteria**).

- Chapter V of the EU SFDR RTS on product disclosure in periodic reports – by requiring a separate graphical representation of the proportion of aggregated investments in nuclear and fossil gas activities identified as being environmentally sustainable activities in accordance with the additional climate technical screening criteria.

- The templates in Annex II to V of the EU SFDR RTS – by replacing them in their entirety with the relevant annexes in the amending RTS which have been revised to ensure that they are in line with the changes introduced by the Taxonomy Complementary Climate Delegated Act.

These amendments were adopted by the Commission on 31 October 2022 and were submitted to the European Parliament and Council who have three months to scrutinise the legislation. The legislation was not published in the Official Journal before 1 January 2023, the start date of the Taxonomy Complementary Climate Delegated Act. However, firms are likely to start using the templates now that the Commission has adopted the changes.

Further amendments to the EU SFDR RTS – mandate on indicators for PAI and financial product disclosures

And still there is more to come on the EU SFDR RTS. On 11 April 2022, the European Commission had sent a letter to the ESAs requesting them to draft amendments to the EU SFDR RTS specifically relating to the indicators for principal adverse impact (**PAI**) and financial product disclosures within a period of 12 months of the receipt of the letter – i.e. by **28 April 2023**.

In terms of the PAI indicators, the Commission invited the ESAs to: streamline and develop further the framework, consider extending the lists of universal indicators for PAIs and other indicators and refine the content of all the PAIs and the relevant definitions, applicable methodologies, metrics and presentation.

In relation to the transparency requirements in relation to financial products, the Commission invited the ESAs:

- To propose amendments to the EU SFDR RTS in relation to information provided in relation to financial products in pre-contractual documents, on websites, and in periodic reports on **decarbonisation targets**, including intermediary milestones, where relevant, and the actions taken. Here, the ESAs were specifically instructed to seek input from a number of external bodies, including the European Environment Agency and Joint Research Centre of the European Commission, as well as certain decentralised agencies.

- To consider whether the provisions in the EU SFDR RTS regarding financial products referred to in Articles 5 and 6 of the EU Taxonomy Regulation (i.e. Article 9 EU SFDR products with sustainable investment (or reduction in carbon emissions) as their objective and Article 8 EU SFDR products which promote environmental or social characteristics) sufficiently address the disclosure an information on environmentally sustainable economic activities.

On 26 October 2022, the ESAs wrote back to the Commission saying that they would not be able to meet the Commission's April 2023 deadline for delivery of the requested amendments.

There were several reasons as to why the ESAs were unable to meet the deadline (although they took the opportunity to point out that, since the Commission's mandate relates to amendment to the existing rules set out in the EU SFDR RTS, the submission of these RTS is not subject to a deadline under the EU SFDR):

- Consultation on technical issues with so many agencies and expert bodies was proving time-consuming.

- A three-month consultation with external stakeholders would be required.

- Revising and extending PAI indicators (and their respective definitions, applicable methodologies, metrics and presentation) is a substantial and technically complex exercise. As part of this exercise, although this was not explicitly mentioned by the

Commission's mandate, the ESAs consider that it is important to develop a more objective basis to the Do Not Significantly Harm (DNSH) framework and to expand the social indicators to a significant extent.

- During the implementation process, the ESAs have identified a number of substantial issues with the EU SFDR RTS as originally drafted that were not fully or adequately addressed.
- During the period from receipt of the Commission's letter, the ESAs were engaged in urgent work on delivering the amendments to the EU SFDR RTS in relation to nuclear energy and fossil gas, and so were not able to devote as much intensive focus on the mandate as they would have liked.

In light of the above, the ESAs said that there would be a delay of up to six months – so, the ESA's proposed amendments are unlikely to be published until **November 2023**.

Q&As on the EU SFDR RTS

On 17 November 2022, the European Supervisory Authorities published a set of Q&As on the EU SFDR Delegated Regulation (i.e. the EU SFDR RTS). This includes Q&As on the current value of all investments in PAI and Taxonomy-aligned disclosures, PAI disclosures, financial product disclosures, multi-option products and Taxonomy-aligned investment disclosures. There is also a section on financial advisers and execution-only FMPs.

The ESAs' Q&As on EU SFDR follow those from the European Commission in relation to the interpretation of EU SFDR and the EU Taxonomy Regulation earlier in the year.

Commission work on EU SFDR

Mairead McGuinness, the European Commissioner for Financial Services, Financial Stability and Capital Markets Union indicated in a speech in December 2022 that the Commission will be publishing its first set of Q&As on EU SFDR early in 2023, to address how some of the Regulation's fundamental concepts should be understood and applied. These will pick up on the concerns raised by the European Supervisory Authorities in the SFDR queries they forwarded to the Commission in May 2022 and September 2022. At the same time, the Commission is working on a comprehensive review of EU SFDR, focusing on issues such as legal certainty, usability, and the mitigation of greenwashing. A public consultation is promised, alongside industry workshops.

Other EU sustainable finance developments – a round up

WHAT IS THIS? A round-up of other EU sustainable finance developments.

WHO DOES THIS APPLY TO? Since this is a round-up, the precise application of individual measures varies. Most provisions apply to EU portfolio managers, investment advisers, AIFMs and UCITS management companies. However, some

provisions also apply to non-EU firms marketing or distributing financial products in the EU and/or certain large or listed companies.

WHEN DOES THIS APPLY? Various.

ESMA consultation on use of ESG or sustainability-related terms in funds' names

On 18 November 2022, the European Securities and Markets Authority (**ESMA**) published a consultation on proposed guidelines relating to the use of ESG or sustainability-related terms in funds' names. Consultation closes on **20 February 2023**. The guidelines are likely to apply in Q2/Q3 2023.

The draft guidelines would apply to both UCITS and AIFs (including those set up as EuVECAs, EuSEFs and ELTIFs) against the backdrop of requirements under EU AIFMD and the EU UCITS Directive to act honestly and fairly, and under the EU Cross-border Distribution of Funds Regulation to be fair, clear and not misleading. ESMA says the proposed guidelines are not intended to "interfere with" EU SFDR or the EU Taxonomy Regulation. Institutional as well as retail funds would be caught.

Neither ESMA's consultative text nor its draft guidelines make any express reference to jurisdictional scope, though the above legislation is clearly EU-only legislation. There is therefore nothing that says that ESMA would expect competent authorities to apply the guidelines in the operation of their national private placement regimes (**NPPRs**) (it is difficult to see that ESMA would have the authority to express such an expectation). Of course, there would be nothing to stop a relevant competent authority to which the guidelines applied from *choosing* to apply them (or elements of them) to its NPPR or, indeed, regardless of such guidelines, from looking to its own domestic laws in determining whether it would be fair, clear and not misleading for an "incoming" non-EU fund to use certain ESG-related terminology in its name.

For further details see our briefing Fund names and greenwashing: ESMA consultation and our Sustainability Insights commentary piece, Greenwashing and the regulation of fund names in the EU.

ESAs Call for Evidence on greenwashing

As mentioned in the previous item, one of the motivations behind – if not *the* primary motivation behind – ESMA's consultation on Draft Guidelines on fund names appears to have been a desire to combat greenwashing. In that consultation, the ESAs called for examples of potential greenwashing practices not covered – or not sufficiently covered – by existing EU legislation.

The fund names consultation followed hot on the heels of the publication by the European Supervisory Authorities (**ESAs**) of a joint Call for Evidence on greenwashing on 15 November 2022. The Call for Evidence (**CfE**) was issued in the light of the mandate that the European

Commission published on 22 May 2022, which requested input from the three ESAs relating to greenwashing risks and supervision of sustainable finance policies.

In keeping with the Commission's mandate, the CfE uses the term "greenwashing" in a broad sense, to include sustainability-related claims relating to all aspects of what the ESAs refer to as the "ESG spectrum" – i.e. environmental, social and governance dimensions. The perceived mischief is clear: the ESAs note the fact that, because of the development of sustainable finance legislation, there is (or may be) an increasing number of misleading claims on environmental topics. The CfE, which is in the form of a questionnaire, is specifically focused on collecting:

- Views on how to understand greenwashing and what the main drivers of greenwashing.
- Examples of potential greenwashing practices in the EU (ESMA made a similar request in its consultation on fund names).
- Available data to help the ESAs to assess the scale of greenwashing and to identify any areas of particularly heightened risks.

The CfE closes on **10 January 2023**. Responses will feed into the ESAs' findings for their progress report due in May 2023, and final report due in May 2024.

For further details, see our Sustainability Insights publication in June 2022, which provided an holistic commentary on The regulatory focus on "greenwashing".

Integration of sustainability risks and factors into EU AIFMD, EU MiFID II and EU UCITS Directive

Three delegated acts integrating sustainability into EU AIFMD, EU MiFID II and the EU UCITS Directive all came into force during 2022.

Very broadly, the delegated legislation requires AIFMs, UCITS management companies and MiFID investment firms to integrate sustainability risks and factors into their policies and procedures.

The relevant provisions came into force as follows:

- *For AIFMs*: Commission Delegated Regulation (EU) 2021/1255, amending the AIFMD Delegated Regulation, applied from 1 August 2022.
- *For UCITS management companies*: Commission Delegated Regulation (EU) 2021/1270, amending the UCITS Implementing Directive, applied from 1 August 2022.
- *For MiFID investment firms*:
    - Commission Delegated Regulation (EU) 2021/1253, amending Delegated Regulation (EU) 2017/565 (the **MiFID Org Reg**), to integrate sustainability factors,

risks and preferences into certain organisational requirements and operating conditions, applied from 2 August 2022.

- Commission Delegated Regulation (EU) 2021/1269, amending the MiFID Delegated Directive to integrate sustainability factors into the product governance obligations, applied from 2 August 2022.

Corporate sustainability: EU CSRD and EU CS3D

There are two separate – but connected – initiatives dealing with corporate sustainability.

Corporate Sustainability Reporting Directive

The Corporate Sustainability Reporting Directive (**EU CSRD**) was originally proposed by the European Commission in February 2021 and will amend a number of existing pieces of EU legislation and largely replace the Non-Financial Reporting Directive. It will apply sustainability reporting requirements to all large companies (whether listed or not) and companies listed on regulated markets (with some exceptions). In addition, it will extend to require information on certain third-country undertakings where relevant in-scope subsidiaries or branches are located in the EU. There will also be proportionate sustainability reporting standards for small and medium-sized undertakings (**SMEs**). Over the summer of 2022, the Council and the EU Parliament reached a political agreement on a revised text; our July 2022 briefing – The ever-expanding world of corporate sustainability reporting – discussed progress on the draft Directive up to that political agreement.

The Directive has now been finalised and was published in the Official Journal on 16 December 2022 and entered into force on 5 January 2023. Member States are required to transpose the provisions of the Directive into their national laws by **6 July 2024**, but there is staggered implementation of the reporting requirements as follows:

- Financial years beginning on or after **1 January 2024**: application to public interest entities already subject to the Non-Financial Reporting Directive (**NFRD**)/non-financial reporting.
- Financial years beginning on or after **1 January 2025**: application to large undertakings and parents of large groups that are not public interest entities.
- Financial years beginning on or after **1 January 2026**: application to SMEs, small and non-complex credit institutions, and captive insurance/reinsurance undertakings.
- Financial years beginning on or after **1 January 2028**: application to non-EU entities.

Corporate Sustainability Due Diligence Directive

The Corporate Sustainability Due Diligence Directive (**EU CS3D**) will require large companies, including third country companies with "significant" operations in the EU, to adequately

diligence their supply chains in order to avoid adverse impacts on the environment and human rights. In March 2022 we published a briefing on the European Commission's proposal in this regard: Corporate Sustainability Due Diligence: A long-awaited proposal revealed.

In early December 2022, the Council of the European Union finalised its negotiating position on EU CS3D. The Council's position on a number of points differs from the Commission's original proposal though it should be stressed that there is still a long way to go before the Directive is finalised. The Council's text will form the basis of discussions with the European Parliament – which will almost certainly take a different view on some of these points. Asset managers and other regulated financial undertakings will need to keep an eye on how negotiation progresses, not least to determine the likely scope and application of the Directive to EU and non-EU firms.

The (slow) development of an EU Social Taxonomy

From the outset, the EU's sustainable finance strategy has not just been about environmental factors: social aspects have an important part to play too. As the EU Platform on Sustainable Finance (**the Platform**) put it, "it is widely recognised that there is a need for social investments to both: (i) achieve the sustainable development goals (SDGs) of the UN's 2030 agenda; and (ii) create the social internal market set out in the Treaty on European Union (Article 3). It is also widely recognised that businesses must show respect for human rights as envisaged in the UN guiding principles on business and human rights (UNGPs)".

To this end, in February 2022, the Platform published its Final Report on Social Taxonomy. In the Final Report, the Platform proposed a structure of a Social Taxonomy within the pre-existing EU legislative framework on sustainable finance and sustainable governance (i.e. the existing EU Taxonomy legislation, the proposed Corporate Sustainability Reporting Directive (CSRD), the Sustainable Finance Disclosures Regulation (EU SFDR) and the sustainable corporate-governance (SCG) initiative).

The Platform proposed that the Social Taxonomy would be based on three main social objectives, with detailed substantial contribution criteria, a set of "do no significant harm" criteria and minimum safeguards (see below for further details).

The *three main social objectives* (and sub-objectives) would be as follows:

- Decent Work – including for value-chain workers and non-EU workers:
    - The sub-objectives would include promoting decent work; promoting equality and non-discriminate at work; and ensuring respect for the rights of workers in the value chain.
- Adequate living standards and wellbeing for end-users of certain products and services that pose heightened health or safety risks or have the potential to help people meet basic human needs:

    - The sub-objectives would include ensuring healthy and safe products and services; engaging in responsible marketing practices; and improving access to good quality drinking water, food, and housing.

- Inclusive and sustainable communities and societies:

    - The sub-objectives would include promoting equality and inclusive growth; supporting sustainable livelihoods and land rights; and ensuring respect for the human rights of affected communities.

In terms of the proposed *substantial contribution criteria* these would be:

- Avoiding and addressing negative impact on workers, end-users and communities – this would target both sectors with documented human rights and labour rights abuses and also sectors that are less likely to contribute to the objectives of the European social pillar; and the criteria would focus on high-risk sectors as identified under the statistical classification of economic activities in the European Community (NACE)(various NACE versions have been developed since 1970, with NACE Rev.2 being the most recent).

- Enhancing the inherent positive impacts of social goods and services and basic economic infrastructure – the relevant criteria could be based on the concept of availability, accessibility, acceptability, and quality (AAAQ).

- Enabling activities – in other words, the economic activities which have the potential to enable a substantial contribution to be made in other activities.

An economic activity would not need to make a substantial contribution to all the relevant sub-objectives outlined above to qualify as sustainable under the Social Taxonomy.

In terms of the "*do no significant harm*" criteria, in keeping with the DNSH concept applied to environmental activities, economic activities making a substantial contribution to one social objective should not significantly harm any of the other social objectives. It is expected that any DNSH criteria would need to operate at the level of the sub-objectives outlined above.

As regards relevant *minimum safeguards*, the Platform kept to high-level provisional views in the Final Report – these included the observation that they may be a need for environmental minimum safeguards to prevent activities from being classified as socially sustainable where they violate environmental safeguards.

The Final Report also included consideration of two objectives on corporate governance related to sustainability matters, the qualitative and quantitative metrics for determining relevant technical screening criteria (at this stage, the Final Report did not contain any TSC) and the identification of "significantly harmful" activities (i.e. activities which would be fundamentally contrary to social objectives).

The types of disclosure would differ depending on the type of product.

The Platform made it clear that further steps would be required to develop the Social Taxonomy. However, since February 2022 nothing further has happened, at least not publicly. The European Commission had originally promised to publish a report on social taxonomy by the end of 2021, but despite the appearance of the Platform's Final Report, 2022 came to an end without the emergence of any further developments. Various news reports over the summer and autumn suggested that the idea of a social taxonomy had fallen onto the backburner – and had perhaps even been shelved indefinitely – given the Commission's list of other regulatory priorities in the remainder of the 5-year term for the current College of Commissioners. Based on the European Commission's 2023 Work Programme which was published on 18 October 2022 (and which makes no mention of ESG initiatives), it appears that the current Commission does not have any appetite for any further ESG legislation. The widespread expectation now is that nothing substantive will happen on a Social Taxonomy until after the 2024 elections under a new Commission.

UK Sustainable Disclosure Requirements (SDR) Regime and labelling

WHAT IS THIS? FCA consultation on new UK sustainability disclosure regime and the introduction of investment labels.

WHO DOES THIS APPLY TO? All FCA regulated firms as regards the new "anti-greenwashing rule". Otherwise, the new rules will – at the outset – apply to UK asset managers – i.e. full-scope UK AIFMs, small authorised UK AIFMs, UK UCITS management companies and portfolio managers (capturing certain private equity advisory activities). The FCA says that overseas funds and other products are currently not within scope.

WHEN DOES THIS APPLY? The earliest of the requirements – a new "anti-greenwashing" rule would likely become effective on 30 June 2023, with the detailed new rules on investment labelling and sustainability disclosure coming in on a phased basis, starting on 30 June 2024 (at the earliest).

In October 2022, the FCA published CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels, an enhancement of the proposals the regulator had set out in its discussion paper in November 2021. The consultation effectively sets out the FCA's own domestic spin on some of the issues dealt with under the EU Sustainable Finance Disclosure Regulation (**EU SFDR**) – there are undoubtedly some significant similarities, but the FCA is clearly charting its own course. The consultation also introduces a formal product labelling scheme, something which the EU lacks. The UK SDR regime would essentially bolt onto the existing TCFD-aligned reporting rules that are contained in the FCA's Environmental, Social and Governance sourcebook (**ESG**).

Consultation closes on 25 January 2023. A policy statement, including the final rules, is expected by the end of June 2023 – and the first rule – a new "anti-greenwashing" requirement that will be applicable to all regulated firms would come into force immediately, currently expected to

be 30 June 2023. The detailed new rules on investment labelling and sustainability disclosure would be subject to phased implementation periods, with elements first coming into effect for in-scope firms on 30 June 2024 (at the earliest).

In terms of scope and application, the new rules will generally apply to asset managers for the purposes of the FCA's ESG rules: i.e. full-scope UK AIFMs, small authorised UK AIFMs, UK UCITS management companies (and ICVCs that are UCITS schemes without a separate management company) and "portfolio managers". "Portfolio management" has an extended meaning under the TCFD-aligned rules in the ESG sourcebook, which means that private equity and other private market activities consisting of either investing on investments or managing investments on a recurring or ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities will also be caught. At the moment, the FCA says, "overseas products" are out of scope of the requirements, although it is not clear that is quite the effect of the draft rules as regards unauthorised AIFs that are non-UK funds managed by UK AIFMs. In any event, it will be question of "watching this space" to see how and to what extent the requirements will be extended to institutional non-UK funds.

Our briefing, FCA consultation on new UK sustainability disclosure regime and investment labels sets out our initial thoughts on where the FCA is going with its proposals, and looks in detail at what the new rules – as currently drafted – will mean for those affected. Further commentary is also set out in an issue of our regular briefing for the alternative asset management industry, Sustainability Insights: Sustainability labels in the UK.

UK Green Taxonomy

WHAT IS THIS? The development of a UK-specific taxonomy specifying the criteria which economic activities must meet to be considered environmentally-sustainable or taxonomy-aligned – essentially the UK's answer to the EU Taxonomy.

WHO DOES THIS APPLY TO? Corporates, asset managers and asset owners (as well as investment products).

WHEN DOES THIS APPLY? Difficult to say – the dates first proposed for consultation on the UK Green Taxonomy have passed and an alternative timetable has not been announced. GTAG has only just delivered its first tranche of advice – more is to come. The Government's latest statement suggests that the development of a UK taxonomy may be a slow one.

The Roadmap

On 18 October 2021, HM Treasury, the Department for Work & Pensions (**DWP**) and the Department for Business, Energy & Industrial Strategy (**BEIS**) published a joint paper entitled Greening Finance: A Roadmap to Sustainable Investing (the **Roadmap**).

The Roadmap set out the government's high-level policy intentions in relation to two key legislative proposals:

- A new UK **Sustainability Disclosure Requirements** regime (**SDR**) that will build on, and go beyond, existing TCFD-aligned disclosures to which many sectors in the economy are subject – see previous item above on the FCA's recent consultation on this new regime, together with a labelling system.
- A **UK Green Taxonomy** which, from the perspective of the high-level Roadmap, will bear some considerable resemblance to the EU Taxonomy Regulation regime.

The UK Green Taxonomy will set out the criteria (crudely, a set of common definitions) which specific economic activities will have to meet to be considered environmentally sustainable and therefore "Taxonomy-aligned" from a UK perspective.

Comparison with the EU Taxonomy Regulation framework

The framework for the UK Taxonomy looks very like the framework for the EU Taxonomy Regulation. This is not surprising given that the outline framework of the EU Taxonomy Regulation, including the six environmental objectives – which the UK had helped to design and develop – came into force before the end of the UK's Brexit transition period and was consequently "onshored" into UK law.

This means that, as with the EU Taxonomy, there are six environmental objectives:

- Climate change mitigation.
- Climate change adaptation.
- Sustainable use and protection of water and marine resources.
- Transition to a circular economy.
- Pollution prevention and control.
- Protection and restoration of biodiversity and ecosystems.

Each objective will be underpinned by a detailed set of Technical Screening Criteria (**TSC**).

The first two environmental objectives – climate change mitigation and climate change adaptation – will, as under the EU regime, become operational first: 1 January 2023 was the effective date (but see below as regards the government's legislative intention to repeal both the 'onshored' EU Taxonomy Regulation and the statutory requirement to make technical screening criteria by 1 January 2023). On the Roadmap's initial timeline, the relevant criteria were due to be subject consultation in Q1 2022, but as mentioned below this and other indicative dates in the Roadmap have come and gone.

The three tests for Taxonomy-alignment

To be UK Green Taxonomy-aligned an activity will have to meet three tests – it must:

- make a substantial contribution to one of the six environmental objectives – the criteria for determining a substantial contribution will be set out in the relevant TSC;
- do no significant harm to the other environmental objectives – again, the concept of doing no significant harm will be defined in the relevant TSCs for the activity; and
- meet a set of minimum safeguards – these are the minimum safeguards for doing business, constituting alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

Recognition of transitional activities

Although UK Green Taxonomy-alignment will be predicated on reported data and not on forward-looking projections, it will nevertheless recognise transitional activities and enabling activities.

The UK Green Taxonomy will also recognise activities which currently support the transition by enabling substantial contributions to environmental objectives in other sectors, but which are not yet sustainable themselves.

The government will review the effectiveness of the UK Green Taxonomy every three years.

The TSCs

Technical screening criteria will be developed for each of the six environmental objectives. Each set of TSCs will be consulted on and will become law by way of statutory instruments. In terms of timing, the disclosure requirements for corporates will come into force before those for investment products.

The priority will be the development of the TSCs for the first two environmental objectives: climate change mitigation and climate change adaptation. These will be based on the TSCs developed for the climate-related objectives under the EU Taxonomy Regulation.

As mentioned above, the timeline on the development of the TSCs has slipped quite considerably. Originally, the government had a legal obligation to implement technical screening criteria for the first two objectives by 1 January 2023, and said that it expected to consult on drafts of those in Q1 2022, with a view to legislating by the end of 2022. Clearly, we are some way behind schedule and – as mentioned below – the government is repealing the legal requirement to implement the Taxonomy on 1 January 2023.

UK Green Taxonomy and SDR disclosures

Certain companies will be required by SDR to disclose the percentage of their capital expenditure, operational expenditure, and turnover that, in each case, relates to UK Green Taxonomy-aligned activities. Those companies that do not fall under the scope of the SDR mandatory reporting regime, but which conduct activities within the UK Taxonomy may choose to report their alignment.

With that disclosed data, providers of investment funds and products will be required to disclose the extent to which their products are UK Green Taxonomy-aligned based on the underlying assets.

The role of GTAG in the development of the UK Green Taxonomy

The Green Technical Advisory Group (**GTAG**) was established in 2021 with the intention of providing non-binding advice to the UK government on the various market, regulatory and scientific considerations for developing and implementing the UK Green Taxonomy. However, it was not until 7 October 2022 that GTAG published its first independent advice to the government on the development of a UK Green Taxonomy.

The 38-page paper summarises what GTAG calls the first "tranche" of its advice, and necessarily addresses matters at a relatively high level.

- **Advice on onshoring the EU TSC** – in terms of the 'onshoring' of the highly-detailed EU technical screening criteria, GTAG recommends that the government should take an "adopt some and revise some" approach. (However, given that many UK financial market participants will also be subject to the EU framework, close alignment with the EU TSC is desirable, so it may be more accurate to say that the recommendation is to "adopt most and revise a few", where revision is necessary because the relevant EU TSCs are incompatible in the UK.) In other words, the majority of the EU TSC should be onshored as soon as possible (subject to obvious amendments to reflect the UK context) while a small number will require revision prior to adoption. Given the huge amount of work that the EU Platform on Sustainable Finance did (and is continuing to do) as regards the development of the highly detailed technical screening criteria for the EU Taxonomy, and in the light the similarities between the EU and UK taxonomy frameworks, it was perhaps inevitable that GTAG would conclude that the UK should leverage off those as far as practicable.

- **Do no significant harm** – GTAG refers to the fact that there are more than 700 individual DNSH criteria included in the EU TSC; having learned the lessons from the complicated EU implementation process, GTAG sees some significant opportunities to streamline, simplify and improve DNSH compliance requirements – so we may eventually see fewer, more user-friendly DNSH criteria.

- **International interoperability** – GTAG observes that not all jurisdictions have the same approach to taxonomy design – most are codified rather than principles-based and not all have adopted features such as DNSH. The continued development of heterogeneous national taxonomies could exacerbate various problems that are currently faced, including market fragmentation and increased transaction costs. International interoperability is clearly the desired goal, though GTAG recognises that harmonisation of various taxonomies may be challenging. It concludes that a degree of divergence between the UK Green Taxonomy and the EU Taxonomy is inevitable.

- **Taxonomy use cases** – the Advice contains a summary list of Taxonomy use cases, differentiating between high, medium, and low priority in scope and use case items. In terms of the high priority items, this includes:

    - For public and private companies and LLPs (including financial institutions) as a matter of primary focus – addressing the issue of data gaps for financial market participants (**FMPs**) dealing with greenwashing through mandatory reporting will be in scope;

    - For FMPs offering financial products in the UK as a matter of secondary focus (i.e. meaning it feeds into primary use cases, not that it is less important):

        - addressing the issue of greenwashing and encourage better understanding of climate and sustainability risks and opportunities thorough a required reporting level of taxonomy alignment at company level as part of wider mandatory TCFD and other reporting will be in scope; and

        - improving consumer choice and confidence will be a potential use case – e.g. by underpinning universal comply or explain or alternatively mandatory product level disclosure requirements.

The government's UK Green Taxonomy consultation on the TSC for the first two environmental objectives is still awaited - GTAG has made it clear that there are several important issues that the Government should consult on *before* finalising the relevant legislation and GTAG will be publishing further advice and recommendations on these issues later this year, and on other matters, in due course. It therefore remains difficult to pin down a definitive timetable on the development of the UK Green Taxonomy – see the next item which also suggests that things may continue to move quite slowly.

The position regarding the 'onshored' Taxonomy Regulation

On 14 December 2022, the Economic Secretary to HM Treasury published a written statement about the development of the UK green taxonomy, which he acknowledged as being a "complex, technical exercise which is linked to multiple sectors of the economy and various legislative and regulatory frameworks". He noted the challenges that have arisen during the implementation of the EU Taxonomy and that, as regards the development of the UK version, it

is important to proceed carefully. Having received advice from the Green Technical Advisory Group (**GTAG**) (see above), the Government believes that "there is benefit in reviewing its approach to taxonomy development to maximise the effectiveness of our sustainable finance agenda".

In the light of the above, the statement confirmed that there would be no further secondary legislation made under the Taxonomy Regulation in 2022 and that the Financial Services and Markets Bill, when enacted, will repeal retained EU law relating to financial services – this will include the 'onshored' Taxonomy Regulation. HM Treasury intends to repeal the statutory requirement to make technical screening criteria regulations by 1 January 2023. It will then consider how to use its powers to restate and modify retain EU law and "decide whether to change the UK's approach".

A further update will be provided as part of the Green Finance Strategy in early 2023.

Other UK sustainable finance developments – a brief round-up

WHAT IS THIS? A brief round-up of other UK developments as regards sustainable investment and ESG.

WHO DOES THIS APPLY TO? For the FCA ESG rules: UK-authorised asset managers (UK MiFID portfolio managers, UK AIFMs, UK UCITS management companies, UK UCITS funds without an external management company) and private market advisory firms. There will a consultation on brining ESG ratings providers into the regulatory perimeter and making them obtain authorisation.

WHEN DOES THIS APPLY? Varies.

FCA ESG Rules – a brief reminder

By way of reminder, the TCFD-aligned disclosure rules in the FCA's Environmental, Social and Governance sourcebook (**ESG**) came into force on 1 January 2023 for those UK-authorised asset managers with assets under management above £5bn (the rules have been applying to asset managers with AUM of more than £50bn since 1 January 2022). Asset managers will be exempt from the disclosure requirements if, and for as long as, the assets under management or under administration are less than £5 billion.

For those asset managers subject to the ESG rules on 1 January 2023, the deadline for their first entity-level and public product-level disclosures will be 30 June 2024. However, discretionary portfolio managers and AIFMs managing non-listed unauthorised AIFs will be relieved from having to make public product-level disclosures. Instead, they will only be required to make product-level disclosures available to clients, or investors in an unlisted unauthorised AIF, on request in order to satisfy the climate-related financial reporting obligations of such clients or investors. The first such on demand request cannot be made any earlier than 1 July 2024 in respect of any reporting period starting after 1 January 2023.

While in-scope asset managers will be preparing for this first round of disclosures during the course of this year, they will also have to have start to get to grips with the "overlay" to the rules which the new Sustainability Disclosure Regime (SDR) will present – see UK Sustainable Disclosure Requirements (SDR) Regime and labelling above.

ESG Ratings providers

As part of the Edinburgh package of reforms, the government has confirmed that it will be consulting in Q1 2023 on bringing Environmental, Social and Governance (ESG) ratings providers into the regulatory perimeter.

Updated Green Finance Strategy

An updated Green Finance Strategy will be published early in 2023. Among other things, this will include an update on the government's approach to the development of a UK taxonomy (see above).

4 INVESTMENT FUNDS

Introduction

2022 was a busy year for the investment funds industry and 2023 looks to continue this trend.

In Europe, work continues on amending AIFMD (see AIFMD II below) and the European Long Term Investment Fund (**ELTIF**). We discussed the proposed changes to the ELTIF in our briefing and, since then, the final compromise text has been published and is expected to be agreed in the first half of 2023. If agreed then it would then enter into force nine months after publication in the Official Journal. Changes since the original text was published include: amendments to the definition of qualifying portfolio undertaking; a slightly broader list of eligible investments; enhanced suitability requirements; transitional provisions and the possibility of a green ELTIF in the future. The original proposals to increase the limit for the aggregate value of units or shares of ELTIFs, EuVECAs, EuSEFs, UCITS and EU AIFs in the portfolio to 40% of capital and to clarify that the authorisation of an ELTIF should not be subject to a requirement for the alternative investment fund manager (**AIFM**) to be established or carrying on activities in the home member state of the ELTIF have not been taken forward.

In the UK, the review of the UK funds regime continues (see Review of the UK Funds Regime below) and the FCA continues its scrutiny of alternative asset management firms (see FCA's Alternative Supervisory Strategy below) as well as consulting on extending access to the Long-Term Asset Fund (**LTAF**) (see Long-Term Asset Funds below). The Edinburgh Reforms (see Edinburgh Reforms above) have proposed the repeal of the PRIIPs Regulation (see UK PRIIPs and UK Retail Disclosure below) and also the discontinuation of the UK version of the European Long-Term Investment Fund – this is in view of the fact that no ELTIFs have been established in the UK and on the basis that the LTAF is thought to work better for the UK market.

The changes to the EU ELTIF and the LTAF reflect the increasing importance of "retailisation" which aims to increase retail investors' access to alternative investments in order to diversify their current holdings and allow them potentially to benefit from the often greater returns on alternative investments.

AIFMD II

WHAT IS THIS? Proposals to amend AIFMD.

WHO DOES THIS APPLY TO? EU AIFMs and their depositaries.

WHEN DOES THIS APPLY? Likely 2025.

Following the publication by the European Commission in late 2021 of its proposal to amend AIFMD (known as **AIFMD II**), the Council of the European Union (**Council**) and the European Parliament put forward their own proposed amendments. We discussed these at the time in our briefings here and here. Further publications from the European Parliament are expected imminently.

The original text of AIFMD II included proposals in respect of delegation, loan origination, liquidity risk management, data reporting and depositaries and the proposed amendments from the Council and the European Parliament largely built on these. Some of the proposals appeared to be politically driven and are unlikely to make the final cut. However, there were a number of helpful proposals where the Council and the European Parliament seemed largely in alignment. These include proposals to exclude marketing carried on by persons acting on their own behalf from the scope of the delegation requirements, the ability for AIFMs to carry out certain "ancillary services" as part of their AIFM activities and some tweaks to the disclosure requirements.

That said, some of the proposals continue to raise concerns and industry associations have been busy lobbying lawmakers. In particular, the specificities of the final regime around loan origination (which in itself is seen as a positive development) continue to be key concern as do the regulatory reporting obligations and liquidity management tools.

Therefore, although firms know the broad direction of travel, the precise impact of AIFMD II is still not fully clear. Similarly, the timing for AIFMD II is not yet known but current expectations are that it will be finalised during the course of 2023 and take effect sometime in 2025.

Passport notifications for cross-border marketing and cross-border management of AIFs and UCITS

WHAT IS THIS? ESMA's Final Report on draft technical standards (RTS and ITS) on the notifications for cross-border marketing and cross-border management of AIFs and UCITS.

WHO DOES THIS APPLY TO? EU AIFMs and EU UCITS managers.

WHEN DOES THIS APPLY? Q3 2023 (see below).

On 15 December 2022, the European Securities and Markets Authority (**ESMA**) published its Final Report on draft technical standards on the notifications for cross-border marketing and cross-border management of AIFs and UCITS. This follows a consultation held between 17 May and 9 September 2022.

Under both AIFMD and the UCITS Directive, ESMA has the power to draft regulatory technical standards (**RTS**) and implementing technical standards (**ITS**) to specify the information to be provided, as well as the content and format of notification letters to be submitted by UCITS

management companies and AIFMs to national competent authorities to undertake cross-border marketing or cross-border management activities and to provide services in host Member States.

The draft RTS and ITS have been submitted to the European Commission which has three months – extendable by one further month – to decide on whether to adopt them. Once adopted, the legislation will be subject to the non-objection of the Council of the EU and the European Parliament. The RTS and ITS are expressed as applying three months after publication in the Official Journal. Assuming the Commission decides to adopt them, neither the Council nor the European Parliament object and allowing for a possible one-month extension and for the process of getting them ready for publication in the Official Journal, they would likely apply in Q3 2023.

Broadly speaking, the draft RTS set out the information that must be notified by the AIFM or UCITS management company and the draft ITS set out the model notification letters that must be used. There are five model templates:

- Notification letter for the cross-border marketing of UCITS.
- Notification letter for the cross-border management of a UCITS.
- Notification letter for the marketing of AIFs in the home Member State of the AIFM.
- Notification letter for the cross-border marketing of AIFs.
- Notification letter for the cross-border management of EU AIFs.

There is also a model for the notification letter to be made by the competent authority of a management company's home Member State to the competent authority of the host Member State, as well templates for the identification of compensation schemes and attestation of authorisation (under Articles 17(3) and 18(2) UCITS Directive).

Review of the UK Funds Regime

WHAT IS THIS? Proposals for changes to the UK funds regime.

WHO DOES THIS APPLY TO? UK funds and fund managers.

WHEN DOES THIS APPLY? Not yet known but each measure is expected to be taken forward on a different timeframe.

In February 2022, HM Treasury published its proposed next steps for the UK funds regime, largely focused on improving the UK attractiveness for funds, which we discussed at the time in our briefing. This followed a call for input in January 2021 and included a number of regulatory and tax proposals but no specific timeframe for when these would be taken forward.

HM Treasury's proposals included the possibility of an unauthorised contractual scheme for professional investors, review of the REIT regime and consideration of how the distribution of capital from authorised funds could be permitted. The FCA is also considering what (if any) Qualified Investor Scheme (**QIS**) proposals should be taken forward and will consider further the question of segregation of sub-funds, but the general feeling is that LTAFs have addressed some of the issues raised with QIS.

The report also trailed the broadening of retail access to LTAFs which has now been the subject of a consultation from the FCA (see Long-Term Asset Funds below).

Despite a number of representations around limited partnerships (**LPs**), reform in this area was not considered a priority for the government. HM Treasury stated that the government plans to introduce measures to increase transparency around the ownership and activities of LP structures "*when parliamentary time allows*". As regards the question of a LP having a separate legal personality, the report stated that the government will consider this issue further and welcomed additional representations from industry.

HM Treasury also stated that the government did not intend to review fund authorisation timeframes or pursue a "fast-track" authorisation process for professional-only AIFs but that the FCA would consider how to limit questions asked by the FCA of firms late in the authorisation process and whether any guidance on the application process would be helpful.

Finally, the government also proposed to work with industry on promotion of the UK's fund offering abroad.

Long-Term Asset Funds

WHAT IS THIS? Proposed amendments to the LTAF regime to broaden retail access.

WHO DOES THIS APPLY TO? LTAF managers and investors in LTAFs.

WHEN DOES THIS APPLY? Not yet known – final proposals are expected in 2023.

The new LTAF was introduced in late 2021 and we discussed this further in our 2022 New Year briefing. There has been limited take-up of this new investment vehicle with the first application to the FCA only having been made recently but the FCA issued a consultation in August 2022 on broadening retail access to LTAFs and a number of other proposals in respect of LTAFs. It is not clear, however, whether these are intended to, or indeed will, make the LTAFs a more attractive proposition. It is also proposed that some of the measures below would be extended to other illiquid assets.

The proposed changes include extending the scope of permitted retail distribution of LTAFs by treating LTAFs as Restricted Mass Market Investments (**RMMIs**). This would broaden retail access and allow restricted retail investors to invest up to 10% of their investable assets into an LTAF or other RMMI products (in total). The rules on marketing RMMIs (discussed in UK Financial Promotions Regime – FCA rules above) would apply but with some amendments, for example, the 24-hour cooling off period for direct offer financial promotions would not apply. There would also be a specific template risk warning.

Additional requirements for LTAFs would also apply (largely based on the rules applicable to UCITS and NURS) including limits on the types of payment that can be taken from the scheme property of an LTAF; a requirement for fundamental changes (such as changes to the LTAF's objective or policy) to be approved by unitholders; prior written notice to be given to investors in respect of any significant changes to the LTAF (such as fee increases); and regular updates to investors in the event of a suspension of dealing.

Additional investment in LTAFs would also be permitted. Funds of Alternative Investment Funds would be able to invest up to 35% in a single LTAF and 50% in LTAFs in total (subject to conditions) and amendments to the permitted links rules would permit additional distribution to certain types of pension schemes.

A policy statement with the final proposals is expected in early 2023.

UK PRIIPs and UK Retail Disclosure: repeal of UK PRIIPs Regulation

WHAT IS THIS? Consultation on proposals to repeal the UK PRIIPs Regulation and a new retail disclosure framework.

WHO DOES THIS APPLY TO? Persons involved in the manufacture and distribution of PRIIPs.

WHEN DOES THIS APPLY? Not yet known.

In December 2022, as part of the Edinburgh Reforms (see Edinburgh Reforms above), HM Treasury published a consultation on PRIIPs and UK Retail Disclosure.

The consultation sets out the government's intentions to repeal the UK PRIIPs Regulation and asks for views on a new framework to replace it.

The government feels that the current PRIIPs regime is overly prescriptive and that the current disclosure requirements do not always provide result in investors having a clear understanding of the product. In addition, the costs and compliance burden of complying with the PRIIPs Regulation may dissuade firms from making their products available to UK retail investors.

Therefore the government is proposing a more flexible regime to be designed by the FCA. This may include prescriptive requirements for high-risk or complex investments and some standardised wording on certain information such as costs but, in general, the aim is to provide more discretion for firms as to how the relevant information is presented. This represents a move away from the PRIIPs concept of comparability of products which the government does not think is particularly useful for most investors.

The proposed FCA regime may also integrate UCITS and PRIIPs disclosures so that there is just one coherent UK retail disclosure framework.

Very little granular information is provided at this stage and the finer details are expected to be in an FCA consultation at a later date.

The consultation closes on **3 March 2023**.

UK PRIIPs: reminders

WHAT IS THIS? A reminder of the extension of the UCITS exemption in the UK PRIIPs Regulation and of the end of the transition period in relation to DISC and the UK PRIIPs RTS

WHO DOES THIS APPLY TO? Persons involved in the manufacture and distribution of PRIIPs.

WHEN DOES THIS APPLY? See below

Pending the repeal of the UK PRIIPs Regulation as outlined in the previous item, the existing requirements of the UK PRIIPs regime remain in force. By way of reminder:

- The UCITS exemption in the UK PRIIPs Regulation has been extended until **31 December 2026** – this means that:
    - UCITS funds offered to UK retail investors must continue to supply a UCITS key investor information document (KIID) until then.
    - EEA UCITS within the temporary marketing permissions regime (**TMPR**) will need to continue to use the UCITS KIID for UK marketing (as above) but, as from **31 December 2022**, are also required to produce a new-style EU PRIIPS KID.
- The FCA's new Product Disclosure Rulebook (**DISC**) and the amendments to the UK PRIIPs regulatory technical standard (**RTS**) both came into force on 25 March 2022, but were both subject to a transition period which expired on **31 December 2022**.

FCA's Alternatives Supervisory Strategy

WHAT IS THIS? FCA's supervisory priorities for alternative asset management firms.

WHO DOES THIS APPLY TO? Alternative asset management firms.

WHEN DOES THIS APPLY? Now.

In August 2022, the FCA issued a portfolio letter (**Letter**) setting out its supervisory priorities for firms in the FCA's "alternatives" portfolio**.** This mainly includes firms which manage alternative investment vehicles investing in the private markets (such as private equity, credit, real estate, infrastructure, and hedge funds) or which manage and advise on alternative assets directly**.**

The Letter focuses on three main areas of priority for the FCA: consumer needs, integrity of the markets and market abuse, and Environmental, Social and Governance.

We discussed the Letter in more detail in our briefing.

SEC no-action letter

WHAT IS THIS? Expiry of US Securities and Exchange Commission's no-action letter in respect of investment research.

WHO DOES THIS APPLY TO? US broker-dealers providing investment research to UK and EU firms and UK and EU firms receiving investment research from US broker-dealers.

WHEN DOES THIS APPLY? 3 July 2023.

The US Securities and Exchange Commission (**SEC**) indicated in a speech in July 2022 that its no-action letter (**No-Action Letter**) in respect of investment research will expire on 3 July 2023.

The No-Action Letter was originally issued in 2017 following concerns that MiFID II rules requiring payment for research services could require US broker-dealers providing research services to EU managers to be regulated under the US Advisers Act. The No-Action Letter advised that the SEC would not recommend enforcement action against broker-dealers in such cases.

However, this was only intended to be a temporary solution and the SEC is now of the view that firms have had sufficient time to adapt. The No-Action Letter will therefore expire on 3 July 2023 and the SEC does not expect to issue further assurances on this subject.

UK and EU firms which have been relying on the provisions in the No-Action Letter in order to procure research may therefore need to discuss and possibly restructure their arrangements with their US broker-dealers before that date.

5 PRUDENTIAL

EU CRR: RTS on calculation of risk-weighted exposure amounts of CIUs

WHAT IS THIS? Regulatory technical standards under Article 132a(4), EU CRR

WHO DOES THIS APPLY TO? EU credit institutions – as regards their calculation of risk-weighted exposure amounts of collective investment undertakings under the mandate-based approach – most likely in the context of derivatives.

WHEN DOES THIS APPLY? The legislation is now subject to the non-objection process under the scrutiny of the Council and Parliament. Unless they object, it is likely that the RTS will be published in the OJ within H1 2023, and will enter into force on the twentieth day after such publication.

On 24 November 2022, the European Commission adopted a Delegated Regulation on regulatory technical standards (**RTS**) on the calculation of risk-weighted exposure amounts of collective investment undertakings (CIUs) under Article 132a(4) of the EU Capital Requirements Regulation (**EU CRR**). The European Banking Authority (**EBA**) had published a final report a year earlier, on 25 November 2021, setting out the proposed draft RTS.

By way of background, Article 132a, EU CRR (which was introduced by CRR II) sets out three different approaches for the calculation of the minimum capital requirements for those institutions that make equity investments in CIUs: the "look-through approach" (under which, if conditions are satisfied, the institution can look-through to the underlying exposures of the CIU as if it held them itself), the "mandate-based approach" (under which, if the conditions for the look-through approach are not met, the institution must calculate the risk-weighted exposures in accordance the limits set out in the CIU's mandate and relevant law) or the "fall-back approach" (under which, where neither of the previous approaches can be adopted, the bank must apply a fall-back weighting of 1,250%).

Article 132a(4), EU CRR mandated EBA to develop RTS specifying how institutions should calculate the risk-weighted exposure amount under the second of these three approaches – the mandate-based approach – where one or more of the inputs required for that calculation are not available. At the time of developing the draft RTS, the EBA concluded that the mandate was intended to clarify matters when the information for applying the market-based approach is insufficient due to missing inputs for the calculation of exposure values under that approach. However, in the case of funds, where the total leverage of the fund is limited through market risk measures, which do not limit the *actual* exposure amounts by specifying limits for the notional amount of derivatives and for the counterparty credit risk exposure incurred by the CIU, the market-based approach c*annot* apply – the fall-back approach must be used instead. Therefore, EBA understood the mandate as referring to missing inputs for the exposure value

calculation *despite* having information on (i) the maximum extent permitted for investing into exposures attracting the highest risk weight and (ii) the maximum allowed extent of leverage (if applicable). This would be particularly relevant in the case of the underlying risk of a derivative, or regarding the counterparty credit risk associated with the fund's derivative exposures.

The RTS therefore set out:

- How to determine the exposure value of a CIU's positions where the underlying risk of derivatives is unknown – where the CIU's mandate does not exclude that the underlying of a CIU's derivative position constitutes an on- or off-balance sheet exposure, but the exposure value or, in the case of off-balance sheet exposures, the applicable percentage in Article 111 EU CRR (the percentage of nominal value after reduction of specific deductions, depending on the riskiness of the item) is unknown, the institution shall use the full notional amount of the derivative position as the exposure value.

- How to calculate the exposure values for the counterparty credit risk of a netting set of a CIU's derivatives positions – broadly, where the institution cannot calculate the *replacement cost* of the netting set, due to missing inputs, it should use the sum of notional amounts of all the derivatives in the netting set as the replacement cost; and when it cannot calculate the future exposure of the netting set due to missing inputs it should replace it by a figure representing 0.15 x the sum of the notional amounts of all derivatives in the netting set.

The Delegated Regulation is now subject to scrutiny by the Council of the EU and the European Parliament. The institutions usually have two months in which to do this, although either of them can request an extension. If either the Council or the European Parliament objects to the delegated act with the scrutiny period, the legislation will fail (though this is not likely to happen).

UK implementation of Basel 3.1 standards: PRA and HM Treasury consultations – RWAs

WHAT IS THIS? PRA consultation on implementation of Basel 3.1 standards – the element relating to the proposals on risk weights for unlisted equities/CIU investments.

WHO DOES THIS APPLY TO? Banks – but also of indirect relevance to funds as investees.

WHEN DOES THIS APPLY? The implementation date for the PRA's proposals for the implementation of Basel 3.1 is 1 January 2025 (some provisions are subject to transitional arrangements and come into effect later).

The consultations

On 30 November 2022, the PRA published CP16/22: Implementation of the Basel 3.1 standards. The deadline for responses is **31 March 2023**. The document is to be read in conjunction with HM Treasury's own consultation paper on consequential amendments to the onshored version of the Capital Requirements Regulation (**UK CRR**) which was also published on 30 November 2022 and which closes on **31 January 2023**.

The Treasury's consultation addresses, among other things, elements within UK CRR that will be revoked, consequential amendments to those provisions remaining in UK CRR and the future of the UK CRR equivalence regimes. The consultation is not addressed further in this briefing.

The PRA's implementation timetable

The implementation date for the majority of the PRA's proposals is **1 January 2025**, though three areas are subject to transitional arrangements. One of these relates to the implementation of the revised treatment of equity exposures under the standardised approach for credit risk (which we refer to below). Here there will be a five-year transitional period (or phasing in) starting from 1 January 2025 – see below for further details.

The background

As we reported in last year's New Year Briefing, UK banks became subject to a reformulated post-CRR II prudential framework on 1 January 2022. This reflected a number of Basel standards that were included in a revised EU CRR, but which, because they came into force after 31 December 2020 (the end of the Brexit Transition Period), had not been 'onshored' into EU law. However, this implementation of the "initial" Basel III measures was not the end of it. The final set of Basel III standards, also known as "**Basel 3.1**", had been published in December 2017 and addressed additional and new measures on the standardised approach for credit risk, the IRB approach for credit risk, minimum capital requirements for CVA risk, minimum capital requirements for operational risk, the output floor, and the leverage ratio. The included further changes to the assignment of risk weights to equities, including a risk weight of 400% to speculative unlisted equity exposures and a risk weight of 250% to all other equity holdings (other than investments in nationally subsidised investment programmes).

The PRA consultation therefore covers the proposed implementation of the Basel 3.1 standards and mainly addresses the last elements of the reforms – namely, the measurement of RWAs (the denominator of capital ratios).

It is beyond the scope of this briefing to address in detail the many amendments to the rules that will apply to banks, building societies and designated investment firms as a result of the implementation of Basel 3.1. However, there is one aspect of specific note to venture capital and private equity. This relates to equity exposures.

Equity exposures and venture capital

The PRA proposes to remove the use of internal ratings based (**IRB**) modelling to calculate risk-weighted assets (**RWAs**) for 'equity' exposures. *All* equity exposures would therefore be subject to the standardised approach (**SA**), as amended.

Currently, UK CRR requires SA risk weights of 100% or 150% for equities, and a 150% risk weight applies to items identified as "high risk". By comparison, under the "simple risk weight" approach for IRB – the IRB approach that is most commonly used by banks in respect of their equity exposures – the risk weights are 190%, 290% or 370%.

In line with the Basel 3.1 standards, the PRA proposes that all equity exposures should be risk weighted at **250%**, except for "speculative unlisted equity exposures", which will be risk weighted at **400%**.

Speculative unlisted equity exposures will be limited to *venture capital exposures*, with "venture capital" being defined as:

> *'"unlisted" equity investments held with the objective of providing funding to newly established enterprises, including to the development of a new product and related research for the enterprise in order to bring this product to the market, to the build-up of the production capacity of the enterprise or to the expansion of the business of the enterprise.'*

On the face of the definition as drafted, with its reference to "*newly established*" enterprises, this clearly catches venture capital start-ups and other young businesses but arguably does not extend to private equity investment in established unlisted companies.

These new SA equity risk weights would be phased-in over a five-year period under the SA approach:

Time period	Equity exposures not considered venture capital	Equity exposures considered venture capital
1 Jan 2025 – 31 Dec 2025	100%	100%
1 Jan 2026 – 31 Dec 2026	130%	160%
1 Jan 2027 – 31 Dec 2027	160%	220%
1 Jan 2028 – 31 Dec 2028	190%	280%
1 Jan 2029 – 31 Dec 2029	220%	340%
1 Jan 2030 onwards	250%	400%

There will also be an IRB equity transitional approach that will only apply to firms with IRB permissions.

6 MIFID II

ESMA consultation: technical standards on passporting

WHAT IS THIS? ESMA consultation on potential amendments to the existing technical standards on passporting under MiFID II.

WHO DOES THIS APPLY TO? EU MiFID investment firms; market operators operating MTFs and OTFs.

WHEN DOES THIS APPLY? ESMA expects to publish a final report by the end of 2023. This will include suggested amendments to the technical standards which the European Commission will have to adopt.

On 17 November 2022, the European Securities and Markets Authority (**ESMA**) published a consultation paper on its review of the technical standards under Article 34 of EU MiFID II. The existing regulatory technical standards (**RTS**) and implementing technical standards (**ITS**) have applied since 3 January 2018; broadly, the RTS require firms that intend to provide cross-border services without the establishment of a branch to provide certain specific information in their passport notifications while the ITS prescribes standard forms, templates and procedures to transmitting the required information. The consultation addresses certain improvements that ESMA believes could be made to both the RTS and ITS – these include amendments to the forms and templates. The consultation closes on **17 February 2023**. In the light of feedback, ESMA expects to publish a final report by the end of 2023. Following that, the European Commission will consider whether to adopt the proposed amendments.

Broadly, ESMA proposes adding to the items that EU MiFID investment firms are required to provide at the passporting stage, including:

- Further information in the overview of the firm's cross-border activities in relation to the specific Member States in which the firm will actively use its passport to target clients.
- Details of the marketing means that the firm will use in host Member States.
- The language(s) in respect of which the investment firm has the necessary arrangements to deal with complaints from clients in each of the host Member States in which it provides services.
- Details of the firm's internal organisation in relation to its cross-border activities.

7 FINANCIAL MARKETS INFRASTRUCTURE

EU Central Securities Depositaries Regulation – introduction

WHAT IS THIS? Amendments to the EU Central Securities Depositaries Regulation and related legislation including deferral of the mandatory buy-in rules.

WHO DOES THIS APPLY TO? EU central securities depositaries and their participants.

WHEN DOES THIS APPLY? Not yet known.

There has been quite a bit of regulatory activity in respect of the EU Central Securities Depositaries Regulation (**EU CSDR**) over the past couple of years and this will continue for the foreseeable future. A key focus of the activity has been the EU CSDR settlement discipline regime.

In particular, CSDR Delegated Regulation came into force and deferred the application of the EU CSDR mandatory buy-in rules (subject to some transitional requirements for central counterparties (**CCPs**)) until 2 November 2025.

Following its review into EU CSDR which we discussed in our 2022 New Year briefing, the European Commission (**Commission**) has now published its proposal to amend EU CSDR – see Amendments to EU CSDR below.

Finally, the European Securities and Markets Authority (**ESMA**) issued its final report on its amendment to Article 19 of the EU CSDR Regulatory Technical Standards on Settlement Discipline which would allow central securities depositaries (**CSDs**) to collect and distribute the cash penalties in relation to settlement fails for CCP-cleared transactions. This will be sent to the Commission for endorsement and then be subject to non-objection by the European Parliament and the Council.

Proposed amendment of the EU Central Securities Depositaries Regulation

WHAT IS THIS? Proposed amendments to the EU Central Securities Depositaries Regulation (sometimes referred to as the "CSDR Refit Regulation").

WHO DOES THIS APPLY TO? EU central securities depositaries and their participants.

WHEN DOES THIS APPLY? Not yet known.

The Commission's proposal to amend the EU CSDR was issued in March 2022 and we discuss the key points of that proposal below. In late December 2022, it was reported that the Council of the European Union had settled its negotiating position.

Settlement discipline

The main changes proposed related to the settlement discipline regime which has been the subject of a number of deferrals (see EU Central Securities Depositaries Regulation above) and proposed revisions. In particular, it is proposed that the penalty mechanism and mandatory buy-in would not apply to settlement fails caused by factors not attributable to the participants to the transaction or where a transaction does not involve two trading parties.

In addition, mandatory buy-in would apply to financial instruments or categories of transactions designated by the Commission – broadly where it would be a proportionate means to address settlement fails and certain other conditions are met. There is also a proposed power for the Commission allowing it to suspend the buy-in mechanism for specific categories of financial instruments where it considers it necessary to avoid or address a serious threat to financial stability or to the orderly functioning of EU financial markets.

There would also be a pass-on mechanism allowing each participant in a transaction chain to pass-on its buy-in obligation to the failing participant so that only one buy-in is necessary to resolve a chain of transactions. This is intended to prevent a cascade of failed settlements each requiring a separate buy-in process.

Where the economic terms of the transaction at execution of the buy-in differ from the original transaction then it is proposed that either party (rather than just the receiving participant as is currently the case) would be paid the difference. This would have the effect that the buy-in would restore the parties to the same economic position as if the original transaction had taken place.

As regards CCPs, it is proposed to clarify formally that the exemption to the settlement discipline requirements for CCPs only applies when the CCP interposes itself between counterparties. This follows ESMA's guidance in its CSDR Q&As. There would also be a new provision allowing CCPs to establish in their rules a mechanism to cover losses from the application of mandatory buy-ins.

The European Central Bank also issued its opinion on the proposal which, although largely supportive, suggested that mandatory buy-ins should be discarded altogether.

Passporting and third-country CSDs

In order to speed up the passporting process, there would also be the ability for new CSDs to proceed with a passporting request in parallel with an authorisation application. Home competent authorities would also be required to communicate a passporting request to the

host competent authority within one month (rather than the current three months) and host competent authorities would be unable to refuse a passporting request.

Third country CSDs that intend to provide settlement services in relation to financial instruments constituted under the law of a Member State would be required to notify ESMA (and ESMA would develop regulatory technical standards setting out the required information). This is intended to address the current lack of available information.

Prudential and organisational requirements

Prudential and organisational requirements would also be strengthened including amendments to the existing prudential requirements including in respect of liquid resources and funding arrangements; a requirement to monitor and manage risks, including relevant netting arrangements; and a requirement for CSDs to minimise (rather than reduce) the risks associated with the safekeeping and settlement of transactions in securities. In order to speed up the authorisation process, there would be the ability for competent authorities to grant authorisation to a CSD subject to the condition that the CSD has all necessary arrangements in place to comply with EU CSDR when it launches its activities.

Additional proposals include a requirement for a CSD's procedures, in the event of a withdrawal of authorisation, to include the transfer of issuance accounts and records linked to the provision of core services and a requirement for CSDs to submit to the competent authority plans for their recovery or orderly wind-down and update such plans at least every two years.

Other proposals

CSDs authorised to provide banking-type ancillary services would be able to settle cash payments for CSDs and the prohibition on designated credit institutions offering core CSD services would be removed.

There would also be clarification that the law of the Member State under which the securities are constituted and which shall apply in the context of cross-border issuances of securities includes both: (i) the law of the Member State where the issuer is established; and (ii) where different, the governing law under which the securities are issued. This is mainly intended to address the position of certain bonds and is a formalisation of a response provided by ESMA in its Q&As.

Consultations on Outsourcing and Third-Party Risk Management for FMIs

WHAT IS THIS? Consultations on draft supervisory statements relating to outsourcing and third-party risk management.

WHO DOES THIS APPLY TO? CCPs, CSDs and Recognised Payment System Operators and Specified Service Providers.

WHEN DOES THIS APPLY? Likely 2023.

In April 2022, the Bank of England published three consultation papers on outsourcing and third-party risk management in FMI in respect of CCPs; CSDs and Recognised Payment System Operators and Specified Service Providers (**Relevant FMIs**). These complement previous communications from the Bank on operational resilience as discussed in our 2022 New Year briefing.

The proposals include draft supervisory statements by the Bank which are not strictly binding but set out how the Bank intends to assess compliance with the regulatory framework on outsourcing and third-party risk management. It includes guidance as to how the Bank expects Relevant FMIs to meet their obligations under legislation and other regulatory requirements (including the CPMI-IOSCO's Principles for FMI) and also some additional specific requirements and expectations.

Under the draft supervisory statements, the Bank expects Relevant FMIs to consider, not just arrangements which meet the formal definition of outsourcing but all third-party arrangements, such as purchases of certain hardware and software. The Bank also warns that intragroup outsourcing is not inherently less risky.

The draft supervisory statements also cover areas such as the application of obligations on a proportionate basis; governance and record-keeping; the pre-outsourcing phase (including due diligence and risk assessment); outsourcing agreements; data security; access, audit and information rights; sub-outsourcing; and business continuity and exit plans.

The final policy statements were due by the end of 2022.

Extension of the Senior Managers and Certification Regime to FMIs

WHAT IS THIS? Extension of the requirements under the SM&CR to FMIs.

WHO DOES THIS APPLY TO? UK CCPs and CSDs and, in due course, recognised payment systems and their specified service providers. It may also potentially apply to additional payment entities within the payment chain and their associated service providers.

WHEN DOES THIS APPLY? Not yet known.

HM Treasury published, in June 2022, its response to its 2021 consultation on a SM&CR for certain FMIs regulated by the Bank of England (CCPs, CSDs, payment systems recognised under the Banking Act 2009 and specified service providers to such recognised payment systems).

Following this, the FSM Bill introduced an SM&CR for UK CCPs, CSDs and recognised investment exchanges. The proposed SM&CR is largely based on the existing SM&CR for other authorised firms with a Senior Managers Regime, a Certification Regime and Conduct Rules. The FSM Bill also gives HM Treasury the power to apply the SM&CR to credit rating agencies.

HM Treasury has indicated its intention to take forward an SM&CR for UK CCPs and CSDs. No specific date has yet been set for this to come into force.

A new SM&CR is also expected for recognised payment systems and their specified service providers but this will be implemented at a later date and will also potentially include additional payment entities within the payment chain and their associated service providers (see the next item, Consultation on the Payments Regulation and the Systemic Perimeter).

Consultation on Payments Regulation and the Systemic Perimeter

WHAT IS THIS? Expansion of the scope of Bank of England supervision of payments entities and additional powers for the Bank and the Payment Systems Regulator.

WHO DOES THIS APPLY TO? Payment systems, their associated service providers and certain other entities within a payments chain or which provide services to such entities.

WHEN DOES THIS APPLY? Not yet known.

HM Treasury issued a consultation and call for evidence on Payments Regulation and the Systemic Perimeter in July 2022. We discuss some of the main proposals below.

In light of the greater interconnectivity within the payments sector, the government no longer considers that Bank of England supervision should be limited to payment systems and their associated service providers but should be extended to include systemically important entities operating within payment chains. Those entities would include payment entities within the payment chain which pose systemic risk in their own right to the financial system or UK economy as well as their associated service providers. This reflects the overarching principle of *"same risk, same regulatory outcome"*.

HM Treasury does not provide any specific examples of the entities which it considers may fall within this expanded scope but seems to envisage that this may include firms which are already authorised by the FCA. It also acknowledges that there may be some overlap with the proposed CTP framework which would need to be managed and co-supervisory responsibility between the Bank and the FCA would also need to be clarified – with any framework likely to be based on that applicable to stablecoins. Any additional payment entities and/or associated service providers which are designated are also likely to be subject to the SM&CR for FMIs (see Extension of the Senior Managers and Certification Regime to FMIs above).

The Bank would also have some additional powers including additional information gathering powers for the purposes of keeping markets under review to understand systemic risk and the powers to apply limits on the activity of a recognised payments entity (such as upper or lower transaction or value limits). It is also proposed to clarify in law the Bank's existing discretion to

impose a requirement for an entity recognised under the Banking Act 2009 to be established in the UK where it considers it necessary in order to oversee any risks effectively.

Finally, the consultation proposes changes to the powers of the Payment Systems Regulator including the ability to vary and revoke directions, impose penalties for the provision of misleading information to it and require restitution.

The government intends to respond formally to the consultation in 2023.

RTGS Renewal Programme – postponement of migration to ISO 20022

WHAT IS THIS? RTGS Renewal Programme – the migration of CHAPS to ISO 20022 messaging. (The Real-Time Gross Settlement (RTGS) service is the infrastructure that holds accounts for banks, building societies and other institutions, facilitating the movement of money in real time between the account holders, delivering final and risk-free settlement)

WHO DOES THIS APPLY TO? CHAPS Direct Participants

WHEN DOES THIS APPLY? 19 June 2023, with other revised transitional dates for introduction of new RTGS core ledger and settlement engine to follow

On 5 December 2022, the Bank of England announced that the migration of CHAPS payments to ISO 20022 messaging – known as Transition State 2.1 in the RGTS Renewal Programme – will now occur on **19 June 2023** (postponed from April 2023). All CHAPS Direct Participants will need to be able to receive enhanced ISO 20022 payment messages using only the enhanced XML message schemas. This will mean an updated timetable for the migration of RTGS services to ISO 20022, including CHAPS payments, (deferred) net settlement services and settlement/reserves account services.

The postponement of the above migration follows a consultation that the Bank had with CHAPS Direct Participants, looking at the implications of the decision of the European Central Bank (**ECB**) to postpone its TARGET2 ISO 20022 migration from 21 November 2022 to 20 March 2023. SWIFT subsequently took the decision to postpone its cross-border ISO 20022 implementation to the same date. These decisions had a direct impact on the preparedness of UK industry participants; the postponement of Transition State 2.1 to 19 June 2023 should allow them to deal with the ECB and SWIFT transitions before turning to the transition from CHAPS to the ISO 20022 messaging standard.

The postponement will have a knock-on effect on the Bank's milestones and particularly the introduction of the new RTGS core ledger and settlement engine (Transition State 3) which is currently scheduled for spring 2024.

The Bank will be announcing a revised set of milestones and revised dates for Transition State 3 in February 2023.

Extending Confirmation of Payee coverage

WHAT IS THIS? PSR direction to additional payment service providers (PSPs) to offer Confirmation of Payee service to their customers

WHO DOES THIS APPLY TO? Approximately 400 PSPs not currently providing the service

WHEN DOES THIS APPLY? 31 October 2023 for Group 1 PSPs; 31 October 2024 for Group 2 PSPs

The history and evolution of Confirmation of Payee in the UK

Confirmation of Payee (**CoP**) is a systemised service that was designed to reduce the incidence of some types of authorised push payment (APP) fraud (i.e. where a person or business is essentially tricked into sending money to a fraudster posing as a genuine payee) and accidentally misplaced payments. It does this by checking whether the name of the payee's account matches the name and account details provided by a payer.

The PSR had introduced Phase 1 of CoP in August 2019, when it gave Specific Direction 10 (SD10) to the six largest banking groups, requiring them to implement CoP. At the time of issuing SD10, relevant banks accounted for about 90% of transactions made by Faster Payments and CHAPS. Since SD10, a number of other PSPs also voluntarily joined the service via Phase 1.

For PSPs to implement CoP they need access to a technical environment for sending and responding to CoP messages – Pay.UK Limited (the payment system operator of the Bacs, FPS and ICS payment systems) had worked with the Open Banking Implementation Entity (OBIE) to develop the technical environment and rules and standards in phases. By February 2022, Phase 2 had been developed. For those PSPs that had been directed under SD10 (and those who voluntarily joined) they used Phase 1. Any new joiners to the CoP service could only operate in the Phase 2 environment. This had led to a situation known as "dual-running": with two technical environments and two sets of rules and standards. The PSR consulted in December 2021 on a draft direction to bring such dual-running to an end and move to a single technical environment with a single set of rules.

On 11 February 2022, the PSR gave a new direction which had the effect of terminating CoP Phase 1 on 31 May 2022 and revoking SD10. In May, the PSR consulted on extending CoP coverage by directing approximately 400 more financial firms to introduce the service.

The extension of Confirmation of Payee

On 11 October 2022, the Payment Systems Regulator (**PSR**) published its response in PS22/3: Extending Confirmation of Payee coverage. This confirms that the extension of CoP coverage will be phased across two groups. This extension was formalised by the publication, at the same time, of Specific Direction 17 on expanding Confirmation of Payee under which the PSR gave a

specific direction to Group 1 and Group 2 PSPs to have and use a system to send CoP requests to its customers and to respond to CoP requests made to it by certain dates:

- **Group 1: 31 October 2023**: 32 named PSPs that will be required to use the CoP system with "send and respond capability" after 31 October 2023. These PSPs are listed in the Schedule to SD 17 and were chosen by the PSR based on their size and complexity: the list includes well-known institutions such as Citibank UK Limited, Metro Bank plc, Bank of Ireland (UK) Limited, Yorkshire Building Society, Skipton Building Society, Coventry Building Society, Sainsbury's Bank plc, Standard Chartered Bank, BNP Paribas, Deutsche Bank AG and Bank of America NA.
- **Group 2: 31 October 2024**: all other PSPs, either using unique sort codes, or that are building societies using alternative reference information (SRD reference type), will be required to use the CoP system with "send and respond capability" after 31 October 2024.

The PSR has made it clear that it expects firms to implement a compliant CoP system well ahead the published deadlines and not leave it until the last minute.

8 FINTECH

Regulation on a Pilot Regime for DLT Market Infrastructures

WHAT IS THIS? EU pilot regime for the operation of market infrastructure based on distributed ledger technology.

WHO DOES THIS APPLY TO? Persons operating multilateral trading facilities, settlement systems or a combination of the two based on distributed ledger technology in the EU.

WHEN DOES THIS APPLY? 23 March 2023.

Progress has continued on the EU's Digital Finance Strategy which was originally announced in 2020 (see our original briefing). The first piece of legislation to be finalised, Regulation (EU) 2022/858 on a pilot regime for market infrastructures based on distributed ledger technology (**DLT Pilot**), has been published in the Official Journal and will start to apply as from 23 March 2023.

This sets out the requirements for operating market infrastructure based on distributed ledger technology (**DLT**) on a temporary basis for up to six years. The purpose of the DLT Pilot is to gather evidence on the changes that would be needed to existing financial services legislation for a permanent regime for DLT market infrastructures (**DLT Market Infrastructures**) and how to ensure the appropriate protections for investors as well as market integrity and financial stability.

Under the DLT Pilot, DLT Market Infrastructures include DLT multilateral trading facilities (**DLT MTFs**), DLT settlement systems (**DLT SS**) and DLT trading and settlement systems (**DLT TSS**). Broadly, DLT MTFs are multilateral trading facilities which only admit to trading DLT financial instruments and DLT SS are settlement systems which settle transactions in DLT financial instruments against payment or delivery and allow the initial recording or provision of safekeeping services in relation to DLT financial instruments. DLT TSS combine the services of a DLT MTF and a DLT SS.

DLT financial instruments are financial instruments issued, recorded, transferred and stored using DLT. Only DLT financial instruments in the form of shares, bonds and units in collective investment undertakings are within scope of the DLT Pilot.

In order to operate a DLT Market Infrastructure, specific permission must be sought from the competent authority. Once authorised, specific regulatory requirements will apply.

- The requirements for a DLT MTF are generally those applicable to MTFs under MiFID II and MiFIR (unless certain exemptions apply).

- The requirements for a DLT SS are generally those applicable to a CSD under CSDR (unless certain exemptions apply).
- The requirements for a DLT TSS are largely a combination of those applicable to MTFs and CSDs (subject to certain exemptions).

In addition, there are further requirements to address DLT specific risks, including:

- Having clear and detailed business plans describing the activities and services of the DLT Market Infrastructure.
- Publishing the rules applicable to the DLT Market Infrastructure and the rights and obligations of the relevant parties.
- Ensuring appropriate overall IT and cyber arrangements related to the use of DLT and putting in place risk management procedures.
- Having, where relevant, adequate arrangements for the safekeeping of clients' funds and/or DLT financial instruments. Operators of DLT Market Infrastructures will be held liable for the loss of funds, collateral or a DLT financial instrument (unless beyond its reasonable control).

Finally, the DLT Pilot also includes restrictions as regards the quantity of DLT financial instruments that can be admitted to trading or recorded on a particular DLT Market Infrastructure with an aggregate limit of EUR 6 billion.

Regulation on Digital Operational Resilience

WHAT IS THIS? ICT security requirements for financial services firms and oversight of certain third parties providing ICT services to them.

WHO DOES THIS APPLY TO? EU financial services firms and third-party ICT service providers.

WHEN DOES THIS APPLY? 17 January 2025.

In a significant development on the second major piece of legislation in the EU Digital Finance Strategy, the Regulation on Digital Operational Resilience (**DORA**) has now been published in the Official Journal of the European Union and will apply as from 17 January 2025.

Broadly, DORA sets out operational resilience requirements for financial services firms in their use of ICT services and requirements for certain third parties providing those ICT services. DORA is therefore significant not just for financial services entities but also providers of ICT services to financial entities – including those based outside the EU.

ICT services are defined as "*digital and data services provided through ICT systems to one or more internal or external users on an ongoing basis, including hardware as a service and hardware services which includes the provision of technical support via software or firmware updates by the hardware provider, excluding traditional analogue telephone services*". This is an intentionally broad definition reflecting the importance of ICT services to financial entities and to keep pace with technological developments.

Requirements on financial services entities

DORA imposes a number of requirements on EU financial entities making use of ICT services. These are largely intended to consolidate and upgrade the current fragmented rules applicable to EU financial entities.

EU financial entities subject to DORA include full-scope AIFMs, MiFID investment firms, UCITS management companies, credit institutions, CSDs, CCPs, payment institutions, e-money institutions, authorised cryptoasset service providers and trading venues. As a general matter, the requirements are to be implemented on a proportionate basis taking into account a number of factors such as the size, nature and risk profile of the relevant financial entity and its activities.

Small entities that meet the criteria to be microenterprises, investment firms which are considered small and non-interconnected for the purposes of the EU Investment Firms Regulation and exempted payment and e-money institutions may benefit from exemptions from, or a lighter touch application of, some of the requirements.

At a high-level, the requirements in DORA include:

- Governance related requirements, including an internal control and governance framework to manage ICT risks with the management body bearing ultimate responsibility. The ICT risk management requirements include a digital operational resilience strategy, systems and tools to minimize the impact of ICT risk and a business continuity policy.

- ICT-related incident reporting requirements, including a requirement to implement a management process to detect and manage ICT-related incidents, an obligation to classify ICT-related incidents based on specific criteria and an obligation to report promptly major ICT-related incidents to the relevant competent authorities (and, in some cases, clients). Credit institutions and payment and e-money institutions are also required to comply with these obligations in respect of certain operational or security payment-related incidents.

- Digital operational resilience testing requirements, including a requirement for a digital operational resilience testing programme with independent testing at least annually.

- ICT third-party risk management requirements, including adopting a strategy on ICT third-party risk including pre-contractual assessments, notifications and reporting on

certain ICT third-party contracts to the competent authorities and contents requirements for third-party ICT service contracts including rights of access, obligations to provide assistance in the case of an ICT-related incident and co-operation with competent authorities.

EU oversight of critical ICT third-party service providers

DORA also proposes a mechanism for EU oversight of critical ICT third-party service providers (which includes non-authorised entities and non-EU entities).

The assessment of whether an ICT third-party service provider is considered critical for these purposes will be based on a number of criteria including the systemic impact of a failure to provide the relevant services, the degree of substitutability of the ICT third-party service provider and the systemic character or importance of the financial entities relying on the service provider.

EU oversight would include an assessment of whether the critical ICT third-party service provider has in place effective arrangements to manage ICT risks to financial entities and a right for the overseeing authority to request information from the critical ICT third-party service provider and carry out on-site inspections.

Crucially for UK and other non-EU entities, DORA includes a number of provisions specifically aimed at third-country ICT third-party service providers. In particular, EU financial entities may only make use of the services of a third-country critical ICT third-party service provider which has established an EU subsidiary within 12 months of being designated as critical. However, the recitals state that this does not prevent ICT services and related technical support being provided from facilities and infrastructures located outside the EU.

DORA also includes some provisions purporting to allow the overseeing authority to exercise some of its powers in respect of the ICT service provider's premises located in a third-country but these would require the consent of the ICT service provider and potentially co-operation with the relevant third-country competent authority. Therefore, it is not clear how effective these would be in practice.

Third-country ICT service providers may also be prohibited from entering into subcontracting arrangements where the relevant subcontracting concerns a critical or important function of the financial entity and the overseeing authority considers that the subcontracting poses a clear and serious risk to financial stability or to financial entities.

Regulation on Markets in Cryptoassets

WHAT IS THIS? New EU regime for offering or issuing cryptoassets and providing services in relation to cryptoassets. Includes new cryptoasset market abuse rules.

WHO DOES THIS APPLY TO? Persons offering or issuing of certain cryptoassets or providing services related to cryptoassets in the EU. Any persons in respect of traded cryptoassets.

WHEN DOES THIS APPLY? Likely 2024/2025

The European Parliament and Council of the European Union also reached provisional political agreement on the proposed Regulation on Markets in Cryptoassets (**MiCA**) – the third major piece of legislation in the EU Digital Finance Strategy. However, MiCA is not expected to be adopted by the European Parliament and the Council before early-mid 2023. At the time of going to press, the final version has therefore not yet been published and therefore our high-level summary below is based on the agreed text published in October 2022.

MiCA creates a new regime for persons providing services related to cryptoassets or engaged in the offering or issuance of certain cryptoassets in the EU. It also includes a bespoke market abuse regime in respect of cryptoassets.

For these purposes, cryptoassets are defined as "*a digital representation of a value or a right which may be transferred and stored electronically, using distributed ledger technology or similar technology*". Most financial instruments which are covered by existing financial services legislation, such as MiFID financial instruments, deposits, structured deposits and securitisations, are excluded as are cryptoassets which are unique and not fungible with other cryptoassets (such as NFTs). There are also additional sub-categories of cryptoassets in the form of asset-referenced tokens (likely to include the majority of stablecoins) and electronic money tokens.

Cryptoasset service providers

Cryptoasset service providers will need an effective EU presence and specific authorisation to provide cryptoasset services to third parties (except in genuine cases of reverse solicitation – ESMA is to develop guidelines on this). Investment firms, AIFMs, UCITS management companies, credit institutions, CSDs, market operators and e-money institutions will generally be able to provide cryptoasset services under their existing authorisation (subject to certain notification requirements).

Cryptoasset services include custody and administration of cryptoassets, operating a crypto-trading platform, and placing, executing and receiving and transmitting orders for cryptoassets. Portfolio management of cryptoassets and advising on cryptoassets are also considered to be cryptoasset services.

Authorised cryptoasset service providers may also benefit from a "passporting" regime permitting them to provide services both through a branch or on a cross-border services basis.

A number of organisational rules apply to cryptoasset service providers including prudential requirements, rules on the management body and rules on outsourcing. They must also meet

certain conduct of business requirements such as acting honestly, fairly and professionally, complying with rules on conflicts of interest and provision of information and establishing a complaint handling procedure. There will also be a change in control regime for cryptoasset service providers and activity-specific requirements will apply depending on the services being provided.

Offerings and issuance of cryptoassets

Cryptoassets (other than asset-referenced tokens and electronic money tokens)

Issuers of cryptoassets (other than asset-referenced tokens and electronic money tokens – see below) are required to comply with certain obligations in order to offer these to the public in the EU. There are, however, certain limited exceptions to this such as where the cryptoassets are offered for free.

These obligations include that the issuer is a legal entity and has drawn up a cryptoasset white paper which includes certain detailed specified information (such as a description of the issuer and the applicable risks) and which is notified to the competent authorities. Exemptions to drawing up a white paper apply to certain offerings of cryptoassets including where they are offered to fewer than 150 persons per member state or offerings solely targeting qualified investors.

There are also requirements for marketing communications, including that the information is fair, clear and not misleading, as well as general requirements to act honestly, fairly and professionally and prevent and manage conflicts.

Similar provisions (but not the exemptions to drawing up a white paper) also apply for persons seeking admission of cryptoassets to trading on a trading platform.

Asset-referenced tokens

An asset-referenced token is "*a type of crypto-asset that is not an electronic money token and that purports to maintain a stable value by referencing to any other value or right or a combination thereof, including one or more official currencies*". The majority of stablecoins are likely to be considered asset-referenced tokens. Due to their potential for wide adoption and risks to market integrity, issuers of asset-referenced tokens are subject to more stringent requirements than other cryptoasset issuers.

Persons intending to offer asset-referenced tokens to the public or seek admission of the asset-referenced tokens to trading on a trading platform must be authorised (unless an exemption applies). The requirement for authorisation does not apply to credit institutions (provided that they comply with certain conditions); where outstanding asset-referenced tokens do not exceed EUR 5 million; or to offers of asset-referenced tokens that are exclusively marketed to, and held by, qualified investors. A change in control regime for issuers of asset-referenced tokens will also apply.

A cryptoasset white paper is also required which must include certain detailed information and be approved by the relevant competent authority.

There are also provisions seeking to monitor and limit the impact of asset-referenced tokens within the EU. These include a requirement to take action to ensure that transactions per day in asset-referenced tokens used as a means of exchange do not exceed 1 million transactions (and EUR 200 million in value) within a single currency area. Quarterly reporting to the competent authority is also required for asset-referenced tokens with a value issued higher than EUR 100 million.

Prudential, governance and conduct of business requirements for issuers of asset-referenced tokens will also apply. These include a minimum own funds requirement and rules on holding a segregated reserve of assets backing the asset-referenced tokens. Conduct of business requirements include obligations to act honestly, fairly and professionally and in the best interests of holders of the asset-referenced tokens. Issuers will have to comply with rules on conflicts of interest and marketing communications and also provide information to token holders and competent authorities. Issuers will also need recovery and redemption plans.

Additional obligations apply to issuers of "significant" asset-referenced tokens, such as a remuneration policy, higher own funds requirements and a liquidity management policy.

Electronic money tokens

An electronic money token (or e-money token) is "*a type of crypto-asset the main purpose of which is to be used as a means of exchange and that purports to maintain a stable value by referring to the value of a fiat currency that is legal tender*".

A person intending to offer electronic money tokens to the public in the EU or to seek admission to trading on a cryptoasset trading platform must generally be an authorised credit institution or electronic money institution and also the issuer of those electronic money tokens.

An offering of electronic money tokens requires pre-notification to the competent authority and a cryptoasset white paper with certain specified information including information on the issuer, the tokens and the relevant risks.

Electronic money tokens are also deemed electronic money for the purpose of the Electronic Money Directive and issuers of electronic money tokens must generally comply with the Electronic Money Directive (with some modifications) as well as further specific obligations such as rules on marketing communications and a requirement to have recovery and redemption plans.

Additional obligations also apply to issuers of "significant" electronic money tokens including a requirement to hold a segregated reserve of assets and to have a remuneration policy.

Market abuse

MiCA also includes provisions to prevent market abuse involving cryptoassets admitted to trading on a trading platform for cryptoassets (or for which a request for admission to trading on such a platform has been made).

These are largely based on those in the Market Abuse Regulation and include prohibitions on insider dealing, the unlawful disclosure of inside information and market manipulation.

Issuers with cryptoassets admitted to trading (or persons seeking admission to trading) will also be required to make disclosures of inside information. Persons who professionally arrange or execute transactions in cryptoassets will also be required to have systems and procedures to monitor and detect market abuse and make suspicious orders and transactions reports to the relevant competent authority.

Law Commission consultation: Digital Assets

WHAT IS THIS? Consultation paper on law reform to accommodate digital assets.

WHO DOES THIS APPLY TO? Persons interested in the law on digital assets.

WHEN DOES THIS APPLY? N/A

In July 2022, the Law Commission issued a consultation paper setting out proposals for law reform in respect of digital assets under the law of England and Wales. This is intended to seek views from interested parties prior to issuing its final recommendations to the UK government.

Although the Law Commission acknowledged that that the law of England and Wales has largely been sufficiently flexible to accommodate digital assets, it considered that certain aspects of the law need reform to ensure that digital assets benefit from consistent legal recognition and protection.

Therefore, the Law Commission suggested that digital assets should be included in a new, third category of personal property which would be distinct from things in possession and things in action and called "data objects". It was suggested that this could encompass data represented in an electronic medium which exists independently of persons and the legal system and which is "rivalrous" (a thing is rivalrous if use or consumption of the thing by one person, or a specific group of persons, inhibits use or consumption of the thing by one or more other persons). This could be achieved by the development of common law or by statutory reform. The relationship between data objects and persons could be based on the concept of control (rather than possession).

Under the proposals, crypto-tokens would be considered data objects and objects of property rights. The Law Commission felt that although many existing rules and remedies could work

effectively with crypto-tokens, there were some areas where specific rules or clarification might be needed, such as certain aspects of transfers of crypto-tokens. The Law Commission also thought that some law reform in respect of crypto-token collateral arrangements would be beneficial.

The Law Commission also discussed the structure of crypto-token custody arrangements. In particular, it was thought that the law on the apportionment of shortfall losses arising out of commingled crypto-token holdings held by an insolvent custodian should be clarified. A number of suggestions were made, with the preferred option being apportionment on a pro rata basis.

Travers Smith also contributed to this response to the consultation from the City of London Law Society in November 2022.

Consultation on a Legal Statement on Digital Securities

WHAT IS THIS? Consultation on a proposed legal statement on the position of digital securities under English law.

WHO DOES THIS APPLY TO? Persons interested in the law on digital assets.

WHEN DOES THIS APPLY? N/A

In August 2022, the UK Jurisdiction Taskforce of LawtechUK (**UKJT**) published a consultation on a proposed Legal Statement on Digital Securities. This follows the 2019 Legal Statement on Cryptoassets and Smart Contracts.

According to the UKJT, there are concerns that the absence of a UK statutory regime governing blockchain and DLT may discourage market participants from using English law for arrangements involving digital securities. The purpose of the statement would, therefore, be to provide clarity as to the types of digital security models that could be supported under English law.

The broad question that the UKJT will address through the statement is whether English private law supports the issuance and transfer of equity or debt securities using blockchain or DLT. The focus is on equity or debt securities constituted or evidenced by reference to blockchain or DLT and not conventional securities whose performance is linked to, or which are collateralised by, digital assets. The statement will not cover matters relating to the regulation of digital securities.

The City of London Law Society provided its views on the consultation with input from lawyers at Travers Smith.

The final statement was expected to be published in December 2022.

Final Guidance on the Application of the Principles for FMIs to Stablecoin Arrangements

WHAT IS THIS? Final statement on the application of the Principles for Financial Market Infrastructures to certain stablecoin arrangements.

WHO DOES THIS APPLY TO? Persons operating systemically important stablecoin arrangements.

WHEN DOES THIS APPLY? Now.

The Committee on Payments and Market Infrastructures (**CPMI**) and the International Organization of Securities Commissions (**IOSCO**) published, in July 2022, their final report with guidance on the application of the Principles for financial market infrastructures (**PFMI**) to systemically important stablecoin arrangements (**SAs**). This follows a consultative report in 2021 and the report largely reflects the consultation version which we discussed in our 2022 New Year briefing.

SAs which perform a transfer function (i.e. for the transfer of coins between users) are considered to be FMI and, if "systemically important", are required to comply with the relevant principles set out in the PFMI. In effect, this means that systemically important SAs will be subject to some of the same regulation as existing FMI, such as CCPs and securities settlement systems.

The report includes considerations to be taken into account when assessing whether an SA is systemically important such as the size of the SA; the nature and risk profile of the SA's activity; the interconnectedness and interdependencies of the SA, and the substitutability of the SA.

The PFMI include guidance on governance, risk management and settlement arrangements. The report also provides guidance on the application of some of the PFMI to systemically important SAs, taking into account the unique features of those arrangements compared to other FMI, such as the use of non-bank assets in settlement, multiple interdependent functions and decentralisation.

9 MARKETS AND TRADING

European Commission Report on the functioning of the EU Securitisation Regulation

WHAT IS THIS? A report from the Commission to the European Parliament and the Council on the functioning of the EU Securitisation Regulation.

WHO DOES THIS APPLY TO? No specific legislative changes are proposed, but the Report will be of interest to originators, original lenders, sponsors, SSPEs and institutional investors.

WHEN DOES THIS APPLY? While the legislative changes proposed at this stage are limited, the Commission does intend to make some changes, on the "next revision" of the regulation, in particular to clarify the jurisdictional scope – and other matters will need to be monitored.

On 10 October 2022, the European Commission published its Report on the functioning of the EU Securitisation Regulation (**EU SR**), fulfilling the mandates under Article 46 of EU SR to report to the European Parliament and the Council on the functioning of the Regulation and under Article 45a(3) of EU SR to report to the co-legislators on the creation of a specific sustainable securitisation framework.

The Report covers a number of important issues: which are listed in summary below. The regulatory framework relating to securitisation appears to be an area where we could see material deviation between the approach in the EU and the UK (judging by the UK Treasury's work in this area to date and the fact that the Edinburgh Reforms specifically contemplate an overhaul of the UK Securitisation Regulation):

- **Jurisdictional scope – non-EU AIFMs marketing AIFs under NPPRs:** the Report confirms the extraterritorial application of the EU SR to non-EU AIFMs in respect of AIFs which they have marketed under NPPRs. This point has always been ambiguous and there has been a variety of market practice. Reading this interpretation at face value, this would require such funds only to invest in EU SR compliant paper (amongst other things). This could be problematic for credit funds with a global focus where the invest in securitisations that do not meet EU risk retention requirements. Trade associations will be monitoring the approach of the European Commission and may undertake further advocacy particularly around express grandfathering and transitional provisions.

- **Jurisdictional scope – transparency requirements:** the Report confirms that "EU institutional investors" as defined under the EU SR) are required to ensure that any non-EU securitisations in which they invest (either themselves, or on behalf of, e.g., their managed funds) comply with the EU SR's transparency provisions in full. For non-EU

issues, this is not always a straightforward matter where they are not expressly seeking EU SR compliance.

- **Jurisdictional scope – the need for interpretive guidance:** Since EU SR does not distinguish wholly EU securitisations from those in which one of the parties is established in the third country, there are questions as to how non-EU parties are able to comply with the EU requirements. The Commission therefore intends to issue some interpretative guidance based on its observations in the Report, together with some amendments to provisions of the EU SR itself in the "next revision" of the regulation.

- **Risk retention:** in the absence of any evidence suggesting that the current risk retention methods permitted by the EU SR are inadequate, the Commission sees no need to change the existing requirements, but invites the European Banking Authority (**EBA**) to continue monitoring the situation.

- **Due diligence and transparency:** in the light of identified shortcomings in the disclosure templates that are required to be submitted to securitisation repositories, the Commission invites the European Securities and Markets Authority (**ESMA**) to look into amending and simplifying the templates to make them more useful for investors – this should include consideration of whether the provision of information on a loan-by-loan basis is actually useful and proportionate in all securitisations in the light of the needs of investors.

- **Private securitisations:** the Commission is unable to reach a conclusion as to whether there is a rise in the number of private securitisations motivated by the desire of avoiding transparency. It therefore asks the Joint Committee of the European Supervisory Authorities (**ESAs**) to continue its monitoring of the volumes of private and public transactions and based on the data collected it will revisit the question at a future date. Although the information available to investors and supervisors from the current Article 7 "standard" templates is considered acceptable, the Commission feels that, since private securitisations are bespoke, more tailored information might be more appropriate. It therefore asks ESMA to draw up a dedicated template for private securitisation transactions. Finally, the Commission sees no need to change the current definition of "private securitisation".

- **STS equivalence:** the Commission notes that the UK is the only jurisdiction outside the EU that has established an STS regime and that, to date, no securitisation regime in a third country "could come close to be considered equivalent to the EU's STS securitisation framework". Consequently, it would be premature to introduce an STS equivalence regime at this stage.

- **Sustainable securitisation:** while there is currently no case for creating a dedicated sustainability label for securitisations, there is a need to develop principal adverse impact (**PAI**) disclosures relating to certain types of underlying assets in STS transactions which

should be incorporated into the regulatory technical standards that the ESAs are currently developing.

- **Prudential treatment:** the Commission is required to submit a report to the co-legislators under Article 519(a) of the EU Capital Requirements Regulation (**EU CRR**) on the application its provisions relevant to the securitisation markets. On 17 October 2021, the Commission had issued a call for advice to the Joint Committee of the ESAs asking whether the existing securitisation prudential framework is appropriate. On 12 December 2022, the Joint Committee provided its advice on the review of the securitisation prudential framework. In terms of the banking regulatory framework, the recommendations were:

    - To make technical fixes to the prudential framework – however, at this stage, re-calibrating the securitisation capital framework generally for banks would not be a solution that would ensure the revival of the securitisation market – any changes to the capital framework may have limited impact, because investor demand may remain subdued for the foreseeable future. However, the exception to this general picture seems to be the significant risk transfer (SFT) market, particularly synthetic securitisations which are eligible to use the STS label.

    - To make changes aimed at improving the risk sensitiveness of the framework, recognising the reduced risks associated with originators.

    - To undertake further work on the securitisation risk weight formulae, potentially involving discussion with the Basel Committee on Banking Supervision (**BCBS**).

    - To keep the current liquidity framework (particularly as to whether securitisations should be categorised as highly liquid assets in the Liquidity Coverage Ratio framework) as is.

EU Credit Servicers Directive – a reminder

WHAT IS THIS? The EU Credit Servicers and Credit Purchasers Directive.

WHO DOES THIS APPLY TO? EU credit institutions, EU credit servicers, EU and non-EU credit purchasers (the latter will need to appoint an EU representative) and EU representatives.

WHEN DOES THIS APPLY? 30 December 2023; for those entities that are carrying on credit servicing activities on that date, the deadline for obtaining authorisation under the Directive is 29 June 2024.

For an outline of the EU Credit Servicers Directive see our 2022 New Year Briefing. Just by way of reminder in terms of application:

- EU Member States must transpose the Directive into national law by 29 December 2023 at the latest.
- Those transposed measures must apply from **30 December 2023.**
- Any EU firms carrying on credit servicing activities on 30 December 2023 must obtain permission from their home state competent authority by **29 June 2024**.

UK Short Selling Regulation Review – Call for Evidence

WHAT IS THIS? As part of The Edinburgh Reforms, a Call for Evidence on the shape of regulation that should replace the UK Short Selling Regulation.

WHO DOES THIS APPLY TO? All interested parties, including those currently subject to the UK Short Selling Regulation – issuers, securities lenders, trading venues, investors and other market participants.

WHEN DOES THIS APPLY? No date has been given as to when a UK replacement might be in force.

On 9 December 2022, as part of the government's ambitious package of Edinburgh Reforms announced by the Chancellor that day, HM Treasury published a Call for Evidence, marking the first stage in its Short Selling Regulation Review. The Call for Evidence seeks view on how the government might reform the regulation of short selling, against the backdrop of the overall programme of repealing and replacing retained EU law in financial services. The consultation closes on **4 March 2023**.

As with many other aspects of UK financial services following Brexit, the practice of short selling is regulated in the UK by an 'onshored' version of an EU regulation, the Short Selling Regulation (**UK SSR**). However, following the Future Regulatory Framework Review and its outcomes, which are implemented in the Financial Services and Markets Bill, the UK SSR (together with many other EU-derived pieces of legislation) will be repealed. The Call for Evidence therefore represents the first step towards replacing UK SSR with a model specifically tailored to the UK and its markets.

The Call for Evidence focuses on the short selling of shares admitted to trading. It does not look at other provisions currently contained in the UK SSR, such as the short selling regime for UK sovereign debt and UK sovereign credit default swaps. These will be considered separately.

Among other things, the Call for Evidence seeks views on the following:

- The dynamic and interaction between the UK SSR and other 'onshored' requirements such as the UK Market Abuse Regulation (**UK MAR**), the UK Central Securities Depositories Regulation (**UK CSDR**), the Securities Financing Transactions Regulation (**UK SFTR**) and the Markets in Financial Instruments regime.

- Whether the current rules which ban "naked" or uncovered short selling and require participants to have "cover" by way of borrowing and locate arrangements are sufficient, and whether those arrangements in conjunction with the current arrangements for settlement discipline are adequate to reduce settlement risks and ensure the orderly functioning of the markets.

- In terms of the requirement to report to the FCA, whether there should be changes to the current reporting thresholds and/or changes designed to improve the availability of information that firms need in order to calculate their short positions.

- In terms of the requirement to make public disclosure to the market where a net short position exceeds 0.5% of the issued share capital of a publicly traded company (with additional reports for each 0.1% change above that threshold), whether this is acting as a disincentive to taking large net short positions.

- The FCA's emergency intervention powers and whether, for instance, short selling bans should be removed from the UK regime (and, if so, what the impact would be), or whether changes could be made to the existing regime to improve the effectiveness of those bans.

- What changes might be made to the existing requirements in relation to third country shares – i.e. the maintenance of a list of such shares that are exempt from the UK SSR and which do not need to be reported.

At this stage the Call for Evidence is exploratory, with no concrete proposals for change.

10 MONEY LAUNDERING AND FINANCIAL CRIME

The new EU AML/CTF package

WHAT IS THIS? A package of four EU legislative measures designed to enhance to EU AML/CFT regime, including the establishment of a new EU AML/CFT central authority.

WHO DOES THIS APPLY TO? All obliged entities under the Money Laundering Directive, payment service providers, intermediary payment service providers, cryptoasset providers (and, in some cases, their affiliates).

WHEN DOES THIS APPLY? The timing has slipped – but assuming adoption of the package measures in 2023, the full regime would likely come into force in 2026/27, following the development by AMLA of technical standards.

The EU's new package of AML/CTF proposals

In July 2021, the European Commission announced a package of AML and CTF legislative proposals. This was to give effect to its 2020 Action Plan for a comprehensive Union policy on preventing money laundering and terrorist financing and strengthening the rules in this regard, under six "pillars":

- Ensuring effective implementation of the existing EU AML/CFT framework.
- Establishing an EU single rulebook on AML/CFT.
- Bringing about EU-level AML/CFT supervision.
- Establishing a support and cooperation mechanism for FIUs.
- Enforcing EU-level criminal law provisions and information exchange.
- Strengthening the international dimension of the EU AML/CFT framework.

In essence, the proposals will involve four pieces of legislation as follows.

The establishment of AMLA: a new EU AML/CTF authority

The Commission's proposed legislation:

- Regulation establishing the Authority for Anti-Money Laundering and Countering the Financing of Terrorism (the **AMLA Regulation**).

The Authority for Anti-Money Laundering and Countering the Financing of Terrorism **("AMLA")** will be a central authority co-ordinating all national AML and CTF supervisors, both inside and

outside the financial services sector. Its roles will include monitoring and assessing money laundering and terrorist financing developments and risks in the EU and in third countries and monitoring and coordinating national supervisors and supporting cooperation among national Financial Intelligence Units (**FIUs**).

Although AMLA will not replace national AML and CTF supervisors in the EU, it will have some direct supervisory powers over some of the riskiest financial institutions – these will broadly be those operating in multiple Member States with certain risk factors. The Council of the EU has proposed amendments to this power. AMLA would have powers to investigate and impose fines. Importantly, it will be responsible for developing technical standards, guidelines and recommendations and for maintaining a central database of supervisory information.

The Commission's original intention was for AMLA to be established under the AMLA Regulation on 1 January 2023 with a view to building up operational activities from 2024 and starting its direct supervisory functions in 2026. However, since the AMLA Regulation – together with the other components of the package – is still navigating the EU legislative process, the timing has clearly slipped.

The AML/CTF Regulation

The Commission's proposed legislation:

- Regulation on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (the **AML/CTF Regulation**).

The AML/CTF Regulation will impose directly applicable rules, largely based on the existing Money Laundering Directives. These will include:

- An expansion to the obliged entities that will be in scope, to include cryptoasset providers.
- Measures to be applied by obliged entities, including requirements for internal policies, controls and procedures, risk assessments (based on specified risk variables) and more detailed group requirements (including in relation to third country branches or subsidiaries of an EU parent undertaking).
- More detailed rules on customer due diligence (**CDD**) and beneficial ownership, including:
    - A lower threshold of €10,000 for an occasional transaction to trigger CDD requirements.
    - The prescription of more detailed information to be collected on customers and beneficial ownership.

- Disclosure requirements for nominee shareholders and nominee directors and an obligation for non-EU legal entities which enter into a business relationship with an EU obliged entity or which acquire real estate in the EU to register their beneficial ownership in the EU.
- Restrictions on anonymous accounts, bearer instruments and cash payments over €10,000.

The Sixth Money Laundering Directive

The Commission's proposed legislation:

- Directive on the mechanisms to be put in place by the Member States for the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (the **Sixth Money Laundering Directive** or **MLD 6**).

This will replace the previous Money Laundering Directives, although as noted above, many of the substantive provisions affecting obliged entities will migrate into the directly-applicable AML/CTF Regulation.

However, MLD 6 will also include some new requirements:

- A requirement for licensing or registration of currency exchange and cheque cashing offices and trust or company service providers – together with checks on the senior management and beneficial owners of those entities.
- A requirement for passported electronic money issuers, payment service providers and cryptoasset providers to appoint a central contact point in the relevant host Member States.
- A requirement for Member States to maintain central beneficial ownership registers, as well as bank account and real estate registers.
- Provisions regarding FIUs and supervisors, including a requirement for supervisory colleges where an institution is based in a number of Member States.

Regulation on Transfer of Funds

The Commission's proposed legislation:

- Regulation on information accompanying transfers of funds and certain cryptoassets (the **WTR** (recast)).

The recast WTR will be expanded to include transfers of cryptoassets. It will introduce obligations on the cryptoasset service providers of the originator and beneficiary.

The development of a new EU Single AML and CTF Rulebook

The AML/CTF Regulation and MLD 6 together will fulfil the objective of establishing an EU single rulebook governing AML and CTF.

Timing

Back in 2021, the Commission's ambition was for the overall package to be adopted during 2022 and for the full regime to become operational in 2025 – i.e. three years after adoption. As it happens, none of the above proposals was adopted during 2022, though the recast WTR came nearest: following trialogue negotiations, the Council, Parliament and the Commission reached agreement in October 2022 and the European Parliament is scheduled to consider the legislation during its plenary session in February 2023. The WTR is considered high priority because of the desirability of introducing regulation as regards cryptoasset transfers. However, the other elements of the package still have some way to go in the legislative process.

UK AML/CFT round-up

WHAT IS THIS? A round-up of UK developments in the area of AML/CFT.
WHO DOES THIS APPLY TO? All "relevant persons" under the MLRs.
WHEN DOES THIS APPLY? Various – see below.

Amendments to the MLRs – "time-sensitive" updates

On 21 July 2022, The Money Laundering and Terrorist Financing (Amendment)(No.2) Regulations 2022 were made. They made changes to The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the MLRs).

Most of the amendments are now in force (they came into force on 1 September 2022) except that:

- Some came into force earlier (21 days after the Regulations were made).
- Changes relating to the reporting of material discrepancies and amendments to primary legislation come into force on **1 April 2023**.
- The amendments to the so-called "travel rule" for cryptoasset transfers will come into force on **1 September 2023**.

The changes make some "time-sensitive" updates to the MLRs that HM Treasury had identified in June 2022, as a result of the consultation it ran in the summer of 2021.

The key changes are summarised below.

Change in scope to reflect latest risk assessments – AISPs no longer in scope

Account Information Service Providers (**AISPs**) have been removed from the regulated sector. However, Payment Initiation Service Providers (**PISPs**), Bill Payment Service Providers (**BPSPs**) and Telecoms, Digital and IT Services Providers (**TDIPSPs**) all remain in scope.

Copies of SARs

AML/CTF supervisors are now able to ask to see a copy of any Suspicious Activity Report (**SAR**) made to the National Crime Agency (**NCA**) provided it is necessary to fulfil their supervisory functions.

Proliferation Financing Risk

New Regulation 18A, MLRs implements FATF standards by requiring relevant persons to identify and assess the risks of proliferation financing, taking the following into account:

- The risk assessment that HM Treasury itself is now required to make.
- The firm's risk factors (e.g. customers, geographic, products or services, transactions and/or delivery channel).
- The size and nature of its business.

It must keep a record of that risk assessment and must also establish and maintain policies, controls and procedures to mitigate and manage effectively proliferation financing risks – remember, such policies, controls and procedures should have been in place by 1 September 2022.

"Proliferation financing" is a broad concept – it means the act of providing funds or financial services for use, in whole or in part, in the manufacture, acquisition, development, export, trans-shipment, brokering, transport, transfer, stockpiling of, or otherwise in connection with the possession or use of, chemical, biological, radiological or nuclear weapons, including the provision of funds or financial services in connection with the means of deliver of such weapons and other CBRN-related goods and technology, in contravention of a relevant financial sanctions obligation.

The definition of "Trust or Company Service Provider" and the definition of "business relationship"

This definition of "Trust or Company Service Provider" has been expanded to cover the act of "forming a firm", so that it covers the formation of all types of business arrangement, not just companies and other legal persons.

The definition of "business relationship" has also been amended so that it applies:

- when a Trust or Company Service Provider (**TCSP**) forms all types of business arrangement that are required to register with Companies House,
- when a TCSP provides the service of acting (or arranging for another person to act) as a director or secretary of a company, as a partner of a partnership or in a similar capacity in relation to other legal persons, and
- when a TCSP provides the service of acting (or arranging for another person to act) as a trustee of an express trust or similar arrangement or as a nominee shareholder for a person other than a company whose securities are listed on a regulated market,

whether or not, in any such case, the relationship is otherwise expected to have an element of duration.

Among other things, these amendments will cover a situation where there is a one-off appointment of a limited partner, meaning that CDD would need to be conducted by the TCSP on the limited partner if it is a "customer" of the TCSP.

Reporting of material discrepancies – comes into force 1 April 2023

Under Regulation 30A(1) of the MLRs, relevant firms were already required to collect proof of registration (e.g. on the PSC Register or trust beneficial ownership register) or an excerpt from the relevant register (e.g. of the company, unregistered company, or LLP) and, when establishing a business relationship, to report any discrepancies between (i) the information relating to the beneficial ownership of the customer from such proof of registration or register excerpt and (ii) information which otherwise becomes available to them under the MLRs.

From 1 April 2023, the discrepancy reporting requirement will be expanded to cover *ongoing business relationships* – i.e., it is no longer a "snapshot" requirement at the point of establishing a business relationship.

In addition, from the same date, relevant firms will also need to include entities on the new Register of Overseas Entities as introduced by the Economic Crime (Transparency and Enforcement) Act (see below).

Finally, as amended, the obligation will be to report "*material* discrepancies" (previously there was no concept of materiality). The amendments to the MLRs include a new Schedule 3AZA which provides that, to be caught, a discrepancy must be of a type that, by its nature, and having regard to all the circumstances, it may reasonably be considered to be linked to money laundering or terrorist financing, or to conceal details of the business of the customer. Such discrepancy must be in one (or more) of the following forms:

- a difference in name;
- an incorrect entry for nature of control;
- an incorrect entry for date of birth;
- an incorrect entry for nationality;
- an incorrect entry for correspondence address;
- a missing entry for a person of significant control or a registrable beneficial owner; or
- an incorrect entry for the date the individual became a registrable person.

Transfers of cryptoassets – the "Travel Rule" – in force 1 September 2023

The amendments give effect to the expanded application of FATF Recommendation 16 (regarding information sharing requirements for wire transfers)(the so-called "**Travel Rule**") to cover transfers of cryptoassets. The changes take effect on **1 September 2023** though during the "grace period" leading up to that date businesses are expected to implement solutions to enable compliance with the Travel Rule. Broadly, the changes will be as follows:

- Intermediaries in cryptoasset transfers will be brought within the scope of the MLRs – the amendments to the MLRs make clear that the Travel Rule only applies to intermediaries that are cryptoasset exchange providers or custodian wallet providers (and will not capture others, like software providers).
- There will be a partial exemption for transfers which involve only UK-based cryptoasset firms – here the full information need to be sent with the transfer, but must be provided to the beneficiary cryptoasset business on request.
- A de minimis threshold for cryptoasset transfers has been modified to €1,000 to bring it into line with the FATF recommended threshold (€1,000/$1,000).
- As regards unhosted wallets, cryptoasset businesses will only be expected to collect beneficiary and originator information for transactions identified as posing an elevated risk of illicit finance – the amending Regulations set out the minimum factors that firms should consider when making such a determination of risk.

Changes in Control of Registered Cryptoasset Businesses

A new Regulation 60B and Schedule 6B, MLRs effectively applies Part 12 of the Financial Services and Markets Act 2000 (**FSMA**)(control of authorised persons) to an acquisition of, or an increase in control over, a cryptoasset business, with certain modifications. Proposed acquirers of cryptoasset firms will be required to notify the FCA ahead of an acquisition, enabling the FCA to undertake a "fit and proper" assessment of that proposed acquirer. These requirements came into force on 11 August 2022 (21 days after the amending Regulations were made).

HM Treasury Review of the UK's AML/CFT regulatory and supervisory regime

The amendments to the MLRs outlined above represent what the Treasury saw as "time-critical" updates to the regime, partly to bring the UK in line with FATF recommendations. However, the in parallel the Treasury was (and is) conducting a "slower burn" assessment of the MLRs with a view to amendments that may be needed, or desirable, in the medium-to-long term.

On 24 June 2022, HM Treasury published a Review of the UK's AML/CFT regulatory and supervisory regime (the **Review**) – this was informed by the Call for Evidence which the government had launched in July 2021.

The Review focused on improving the effectiveness of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the **MLRs**) and was structured around elements to ensure systemic, regulatory and supervisory effectiveness.

The Review drew a number of conclusions though many of these were tentative rather than finalised:

- *On supervision*: while the Treasury was clear that reform was needed, it was not yet clear what types of reform would work. A shortlist of possible options had been drawn up and the government would consult.
- *On specific regulations*: the Treasury found that most of the provisions currently in the MLRs were the right ones and should be maintained, but it would be continuing to seek to ensure that UK legislation is further aligned with the FATF recommendations. Among future work streams, the government will be doing further work on domestic PEPs with a view to possibly removing the requirement for automatic EDD, looking into further enhancements to the list of high-risk third countries and consulting on removing the list of mandatory checks for customers in high-risk third countries (except where FATF requires specific EDD measures).
- *On objectives*: a set of clear, new objectives will be set out in the MLRs.
- *On risks*: the government will keep emerging money laundering and terrorist financing under review and will consider adding further sectors to the MLRs.
- *On guidance*: the government will not overhaul the current guidance arrangements – so the JMLSG Guidance Notes will continue to perform an important role – but it will nonetheless seek to make the existing guidance more streamlined, consistent and clear.

The Review indicated a "direction of travel" for the government, in terms of identifying where change is needed and where further work needs to be undertaken, but no specific timetable has been mentioned for when the further work and changes might take place.

Economic Crime (Transparency and Enforcement) Act 2022 – the Register of Overseas Entities

On 15 March 2022, the Economic Crime (Transparency and Enforcement) Act 2022 (ECA) received Royal Assent.

In outline, the ECA:

- Establishes a register of overseas entities and their beneficial owners, and requires overseas entities who own, or who wish to acquire, UK property to register in certain circumstances.
- Makes additional provisions about unexplained wealth orders.
- Makes additional provisions about sanctions.

The details of this Act (and its subordinate legislation) are beyond the scope of this briefing, but for background see the following briefings:

- Economic Crime (Transparency and Enforcement) Act 2022 and the Register of Overseas Entities: who really owns this land?
- 10 frequently-asked-questions about the Economic Crime (Transparency and Enforcement) Act 2022 and the Register of Overseas Entities

However, remember that as from 1 April 2023, relevant persons will be required to report *material* discrepancies under the MLRs. From that date they will also need to include, where relevant, entities on the new Register of Overseas Entities as introduced by the Economic Crime (Transparency and Enforcement) Act in order to determine whether there is a material discrepancy between the beneficial ownership information on that Register and the information that they have in relation to the customer arising out of their duties under the MLRs.

The Economic Crime and Corporate Transparency Bill 2022

The Economic Crime and Corporate Transparency Bill 2022 was published in September 2022 with proposals designed to prevent the abuse of UK corporate structures and tackle economic crime. It includes broader powers for the Registrar of Companies, including identity verification measures, and additional requirements for limited partnerships.

From a financial services perspective, it also includes the following:

- Additional money laundering exemptions for persons in the regulated sector who end a business relationship with a client and hand over property worth less than £1000 or who deal with an account involving a mixture of suspicious and non-suspicious property and retain in the account at least the amount of the property subject to suspicion.
- The granting of a power to HM Treasury under which it will be able to amend the list of high-risk countries for anti-money laundering purposes (rather than requiring a statutory

- instrument). This will enable the government to react more promptly to perceived risks but will also potentially result in more frequent changes to the list which will then need to be reflected by regulated persons in their own money laundering procedures.
- Additional information sharing rights between persons in the regulated sector

Confiscation and forfeiture powers in respect of cryptoassets.

FOR FURTHER INFORMATION, PLEASE CONTACT

Tim Lewis
Head, Financial Services & Markets
tim.lewis@traverssmith.com
+44 (0)20 7295 3321

Phil Bartram
Partner, Financial Services & Markets
phil.bartram@traverssmith.com
+44 (0)20 7295 3437

Stephanie Biggs
Partner, Financial Services & Markets
stephanie.biggs@traverssmith.com
+44 (0)20 7295 3433

Michael Raymond
Partner, Financial Services & Markets
michael.raymond@traverssmith.com
+44 (0)20 7295 3487

Natalie Lewis
Partner, Financial Services & Markets
natalie.lewis@traverssmith.com
+44 (0)20 7295 3673

Danny Riding
Partner, Financial Services & Markets
danny.riding@traverssmith.com
+44 (0)20 7295 3074

Jane Tuckley
Senior Consultant, Financial Services & Markets
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Simon Witney
Senior Consultant, Financial Services & Markets
simon.witney@traverssmith.com
+44 (0)20 7295 3957

Nigel Barratt
Director of Research, Financial Services & Markets
nigel.barratt@traverssmith.com
+44 (0)20 7295 3470

Katherine Foweather
Knowledge Counsel, Financial Services & Markets
katherine.foweather@traverssmith.com
+44 (0)20 7295 3863

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