Aurexia

REGULATORY WATCH

Navigating the Brexit wave

What does the future of regulation look like in the UK?

Sustainable Finance

Everyone is talking about it – what does it really mean?

Horizon Scanning

Key regulatory highlights from the UK and global regulators

UK Edition, October 2019

Foreword

It is with great pleasure that we publish the October 2019 edition of Aurexia's Regulatory Watch newsletter, not least because it is the first one we are publishing from the UK since I joined the firm. As the Brexit drama unfolds, it has been a rush to get this edition published, before we were forced to abandon our front cover. The only certainty at this stage is, if and when Brexit happens, there are a number of changes firms can expect to the regulatory framework in the UK.

There was a string of commitments by 130 global banks ahead of the official launch of the UN Principles for Responsible Banking at the United Nations General Assembly meeting in September. There are many more firms, including asset and wealth managers, who have signed up to the UN Principles for Responsible Investment since 2006. All are asking what sustainable finance and ESG means for them. We explore the regulatory context, key operational considerations for firms, and whether further regulatory intervention is needed.

Lastly, we do not claim to provide you with a complete snapshot of the regulatory news from the past month, however we have included an extract from EROS, our regulatory horizon scanning tool, of regulatory developments in September.

If you have any comments, suggestions, or would like further details on any of the features included in this month's edition, please do not hesitate to contact me.

Manmeet Rana
UK Head - Aurexia

For further information, please contact

Manmeet RANA
Partner at Aurexia
manmeet.rana@aurexia.com
+44 (0) 7946 894918

1 Fore Street
London, EC2Y 5EJ

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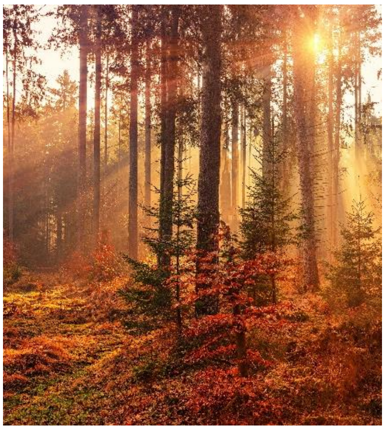
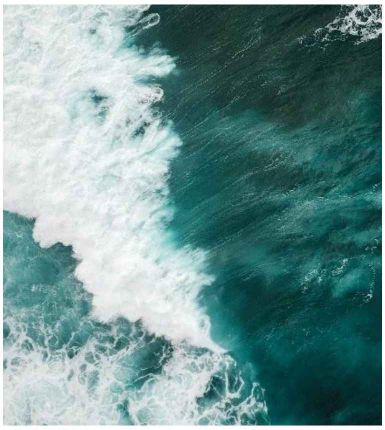




Sustainable Finance

The Regulatory Context

As part of the 2019 United Nations General Assembly, UN Secretary-General Antonio Guterres hosted the Climate Action Summit on 23rd September. Major announcements were made, though the Extinction Rebellion may disagree, to boost momentum around climate change and recognise that the pace of climate initiatives must rapidly accelerate.

65 countries committed to cut greenhouse gas emissions to net zero by 2050, while over 100 major companies delivered concrete actions to align with the Paris Agreement targets adopted in 2015 and to speed up the transition to a green economy.

Among these announcements, a new set of UN Principles for Responsible Banking was officially launched. 130 banks have signed up to these so far. The principles require banks to 'publish and work towards ambitious targets' across six different principles, aligned with the UN Sustainable Development Goals.

Since the adoption of the Kyoto Protocol in 1997, the world has seen a number of initiatives, at both a country and corporate level – the most important one being the 2015 Paris Agreement. Despite international commitments to keep global warming well below the 2 degrees target agreed in Paris[1], the CO_2 stock in the atmosphere is still rising. To meet this target, carbon emissions need to be cut by 45% by 2030 and reach net-zero in 2050[2].

Banks should ensure their willingness to sign up to the UN Principles for Responsible Banking translates into real action, which supports the 2030 commitments. There has been a mixed experience with the adoption of voluntary codes by financial institutions in the past. Regulators may need to ensure there is sufficient incentive.

[1]United Nations Framework Convention on Climate Change, *Paris Agreement*, December 2015
[2]Intergovernmental Panel on Climate Change, Special Report, Global Warming of 1.5 ºC, October 2018

Sustainable Finance

The Regulatory Context

Figure 1

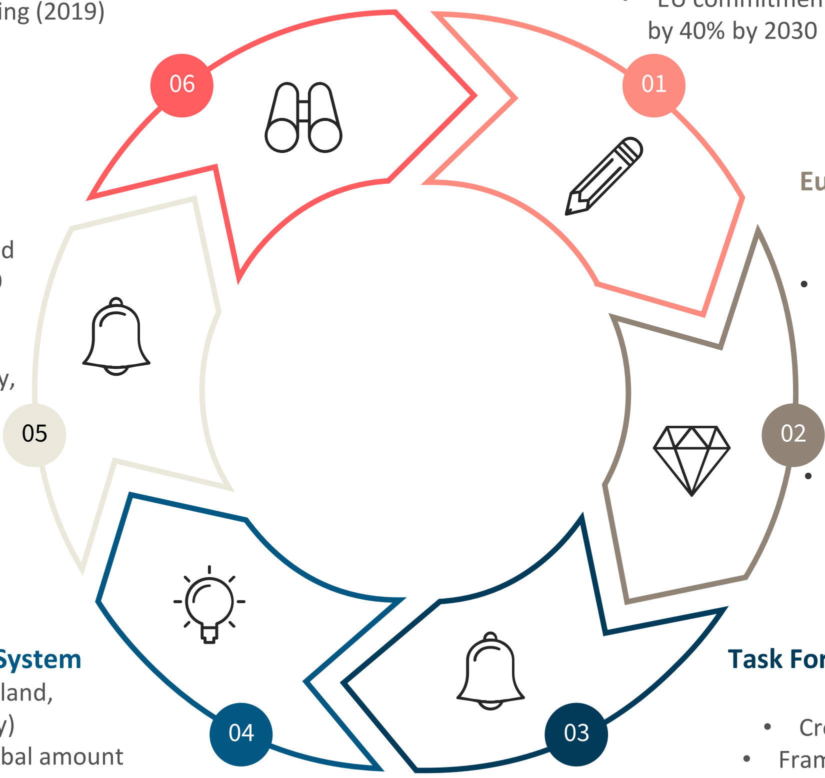
Global initiatives around sustainable finance

United Nations initiatives

- Global Compact (2005)
- Sustainable Development Goals (2015)
- Principles for Responsible Investment (2006), for Sustainable Insurance (2012), for Responsible Banking (2019)

Paris Agreement

- First universal, legally-binding global climate deal
- Adopted by 185 countries following the Conferences of Parties (“COP21”) in December 2015
- EU commitments: reduce CO_2 emissions by 40% by 2030 compared to 1990 levels



UK Green Finance Strategy

- Action plan announced by the UK in July 2019
- Proposals for green finance, as part of the Clean Growth Strategy, 25 Year Environment Plan and Industrial Strategy

European Commission’s Action Plan on Sustainable Finance

- Adopted in March 2018
  - Proposal for a taxonomy
  - Proposal for a regulation on disclosures
- Proposal for amending the benchmark regulation

EU Emissions Trading System

- 28 countries (EU + Iceland, Liechtenstein, Norway)
- A cap is set on the global amount of CO_2 emitted, reducing over time
- Companies can also trade allowances with one another

Task Force on Climate-related Financial Disclosures

- Created in 2015 by the FSB
- Framework for companies to develop more effective climate-related financial disclosures through their existing reporting processes

> *Ultimately, the speed which the new sustainable finance develops will be decided by the coherence and credibitlity of countries’s climate policies. Finance will complement – and potentially amplify these initiatives – but it will never substitute for climate policy action.*

Mark Carney,
Governor of the Bank of England

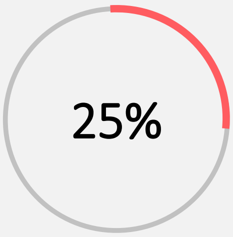
Climate Action Summit, UN General Assembly, New York, 23 September 2019

Sustainable Finance

Implementation of TCFD

In 2015, the G20 asked the Financial Stability Board ("FSB") to consider climate risk and, in the same year, the Financial Stability Board launched the Task Force on Climate-related Financial Disclosures ("TCFD") to develop voluntary, consistent climate-related financial risk disclosures for use by companies to provide information to investors, lenders, insurers, and other stakeholders. The purpose of TCFD is to help measure and respond to climate change risks and encourage corporates to align their disclosures with investors' needs.

Many companies disclose some climate-related information, but more progress is needed



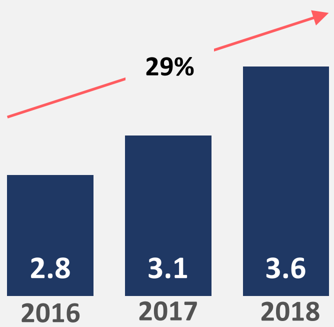
Proportion of companies now disclosing climate-related information in line with > 5 of the 11 recommended disclosures

Support for the Task Force continues to grow

5

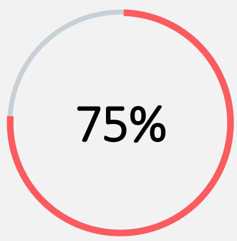
Governments supporting TCFD: Belgium, France, Sweden, the UK, and recently Canada.

The number of recommended disclosures per company has increased, but remains low



Number of recommended disclosures addressed on average by companies

The quality of disclosed information is improving



Proportion of users who cited improvements in the quality of disclosures

Source: Financial Stability Board, *Task Force on Climate-related Financial Disclosures Status Report*, 2019 – Based on an AI review of 1000+ firms' reports

The next step is to make these disclosures mandatory. Unless there is a regulatory imperative, the level of compliance achieved will vary (cf. our case study on the UK Stewardship Code on page 8). In order for TCFD to ultimately succeed, the level of government support also needs to increase. In the absence of this, investors have the power to push for greater disclosures and force change. As UN Secretary-General Antonio Guterres declared while closing the Climate Action Summit, we still 'have a long way to go'[3].

[3]Antonio Guterres, *Climate Action Summit, UN General Assembly*, New York, 23 September 2019

Sustainable Finance

Focus on: the UN Principles for Responsible Banking

So, your CEO has signed your organisation up to the UN Principles for Responsible Banking ("UNPRB"). What are the types of steps you could take to implement these?

Principle 1: Alignment

Aligning your business strategy with individuals' needs and society's goals as expressed in the Sustainable Development Goals ("SDG"), Paris Agreement, and other frameworks. We think firms could:

- Ensure your organisation has reviewed and is familiar with the SDGs and the outcomes of the Paris Agreement.
- Agree a risk appetite statement (decide whether your goal to become ESG neutral or ESG positive).
- Perform an impact assessment across your business to identify potential risk areas (e.g. project finance).
- Work with the business to identify how risks could be mitigated.
- Embed ESG factors into your new business and product approval processes.

Principle 2: Impact and target setting

Increasing your positive impacts while reducing your negative impacts, and managing the risks to people and environment arising from your activities, products, and services. We think firms could:

- Identify the areas where your organisation can have the most impact.
- Set positive targets you are looking to achieve (e.g. to reduce emissions) over a specific timeframe and stick to them.
- Assess the energy efficiency of your organisation and identify ways to enhance this (e.g. use of renewable energy, update travel policy to reduce carbon footprint, assess data centres).
- Implement the results of your impact assessment under principle 1.

Principle 3: Clients and customers

Working responsibly with clients and customers to encourage sustainable practices. We think firms could:

- Communicate your objectives to clients and assess the extent to which their objectives align.
- Provide mentorship and support to your SME clients to help them reduce their negative impacts on the environment and people.
- Perform a risk assessment of your clients to identify any clients that may have a negative impact on your sustainable finance objectives.
- Agree actions with senior management – firms may have little appetite to offboard clients who have a negative impact. However, given the current levels of public interest, firms should ensure they are able to manage reputational risks.

Principle 4: Stakeholders

Engaging with relevant stakeholders to achieve society's goals. We think firms could:

- Identify all key stakeholders (including shareholders, suppliers etc) and assess needs.
- Engage with shareholders to understand their objectives and ESG risk appetite.
- Develop an ESG policy for your supply chain, based on your ESG risk appetite.
- Similar to the Modern Slavery Act 2015, engage with your supply chain to assess their level of compliance with your ESG policy.
- Engage your employees to understand the importance they place on ESG.
- Partner with Non-Governmental Organisations to help achieve your targets.
- Discuss your ESG strategy proactively with your regulators.

Principle 5: Governance and culture

Implement your commitment to these principles through effective governance and a culture of responsible banking. We think firms could:

- Ensure there is regular reporting to the Board on compliance with sustainable finance objectives.
- Review your existing conduct and culture framework to ensure 'responsible banking' is included. Consider updating your culture framework to include sustainability.
- Create policies and train employees on 'responsible banking'.
- Embed ESG into performance management processes to ensure employees are incentivised to consider the 'ESG' in decision making.

Principle 6: Transparency and accountability

Review implementation of principles and be transparent through disclosures. We think firms could:

- Allocate responsibility to deliver compliance with the UN Principles to a Senior Management Function.
- Publish an annual report, setting out their ESG targets, an ESG-specific risk appetite statement, and assessment of their progress.
- Review current disclosures in their annual statements and ensure there is sufficient granularity.
- Work with your auditors to ensure they adequately incorporate your climate change disclosures in their work programme.

Sustainable Finance
Challenges

There seems now, more than ever, to be a genuine interest in driving forward a sustainable agenda. There is increasing pressure from investors, but also regulators. Mark Carney, the governor of the Bank of England, recently stated "Companies that don't adapt, including companies in the financial system, will go bankrupt without question"[5]. There are a number of challenges, we feel, remaining to ensure the current wave of enthusiasm translates into real action.

Definition of ESG

ESG is a broad topic and despite current work by the European Commission's Technical Expert Group on Sustainable Finance to produce a standardised taxonomy, it is inherently subjective. A taxonomy will provide firms with a baseline, but it may not provide the flexibility investors want. For example, investors will have their own judgements on whether large multi-nationals investing in renewable energy outweighs the negative impacts arising from their fossil fuel businesses. There is no right answer. There are a number of steps firms can take though.

By collecting data at its most granular level on ESG factors and preferences from clients and investors, larger firms can ensure different investor preferences are met. Smaller firms may not have the same flexibility.

Brexit

With the potential approach of Brexit, the UK should consider how it will drive ESG initiatives forward outside of the EU's Action Plan on Sustainable Finance. A number of financial institutions in the UK will need to implement the EU sustainable finance requirements for their European businesses. UK regulators should consider to what extent they are willing to implement best practices from Europe to avoid increasing complexity for firms.

Conduct

Conduct has had significant attention since the financial crisis. The definition is currently limited to the impact on customers and markets. If the banks, which have signed up to UNPRB, want to truly embed ESG principles into their culture and their business strategy, they, along with regulators, should consider extending the definition of conduct risk to include impact on the environment. The risk of reputational damage arising from poor conduct in relation to clients, markets, and the environment is similar.

Unless firms ensure ESG is embedded in the culture of the organisation and the definition of conduct risk evolves to include environmental impact, little will change.

The UK Stewardship Code

The UK Financial Reporting Council ("FRC") published the UK Stewardship Code in 2010, though it has been updated since (and is due to be revised again). The code is voluntary and relies on a 'comply or explain' approach.

- More than 300 entities signed up to the Stewardship Code in the first five years of its publication.
- The level of compliance with the code has not been consistent. The FRC noted there was a lack of evidence through disclosures to evidence that "all signatories were following through on their commitment to the Code"[4].

The FRC has taken positive action over the last few years to encourage compliance by assessing signatories and tiering them. This action has resulted in an increase in the number of asset managers in the top tier of compliance from less than 20 to 88 between 2016-17). Those firms in the bottom tier, tier 3. were threatened with being removed from the list of signatories to the code, resulting in more than 20 firms withdrawing voluntarily.

Unless a similar approach is adopted for voluntary codes and principles promoting other ESG factors, such as the UN Principles for Responsible Banking, there is a risk that many firms will sign up to the code, with very few following through on implementation. Greenwashing is a real risk and reputational impacts should be considered by firms.

[4]Financial Reporting Council, *Developments in Corporate Governance and Stewardship 2016*, January 2017
[5]The Guardian, *Capitalism is part of solution, says Mark Carney*, 31st July 2019

Sustainable Finance
Challenges

Data Availability

The market needs better disclosures from companies, as well as access to more insightful data. There are a number of initiatives, including TCFD, to help drive this forward. However, a number of challenges remain. Firstly, only five countries globally have signed up to TCFD[6], therefore global firms may be less incentivised to act. Secondly, unless countries convert these into binding requirements (e.g. as part of listing rules), compliance is difficult to enforce. Thirdly, the level of disclosures may need to be more granular to enable investment screening, catering to different ESG objectives and appetites.

Data Quality

The inherent subjectiveness of the definition of ESG could make it difficult for firms to source and use appropriate external benchmarks and data providers. Firms need to decide the data they care about. For example, consideration of governance factors can run to more than 150 variables. All firms will not want to consider all 150 variables[7]. Some of this will be driven by their clients. The ability to source data in its most granular form, rather than in already compiled and ready to use benchmarks, we think will be critical to provide firms the flexibility they need.

As ESG becomes more of a science and less of an art, companies need to ensure their disclosures are as accurate as possible and follow the same rigour as for their financial statements. Auditors will need to ensure they properly review and challenge ESG disclosures included in annual reports.

Embedding codes into regulation

Financial institutions are taking a number of positive steps to sign up to the UN principles and other voluntary codes. This is, however, voluntary. Global consistency in regulatory standards will only be achieved when there is real pressure from the G20. The FSB's TCFD is a good start, but as we have noted previously, only five countries have signed up to it. As well as pushing companies, clients need more choice and regulators should help push companies to provide this.

[6]Financial Stability Board, *TCFD Status Report*, 2019
[7]Christopher K. Merker, Sarah W. Peck, *Does the Governance of Public Pension Plans Matter?*, 20 March 2018

Navigating the Brexit Wave

The Future of Regulation

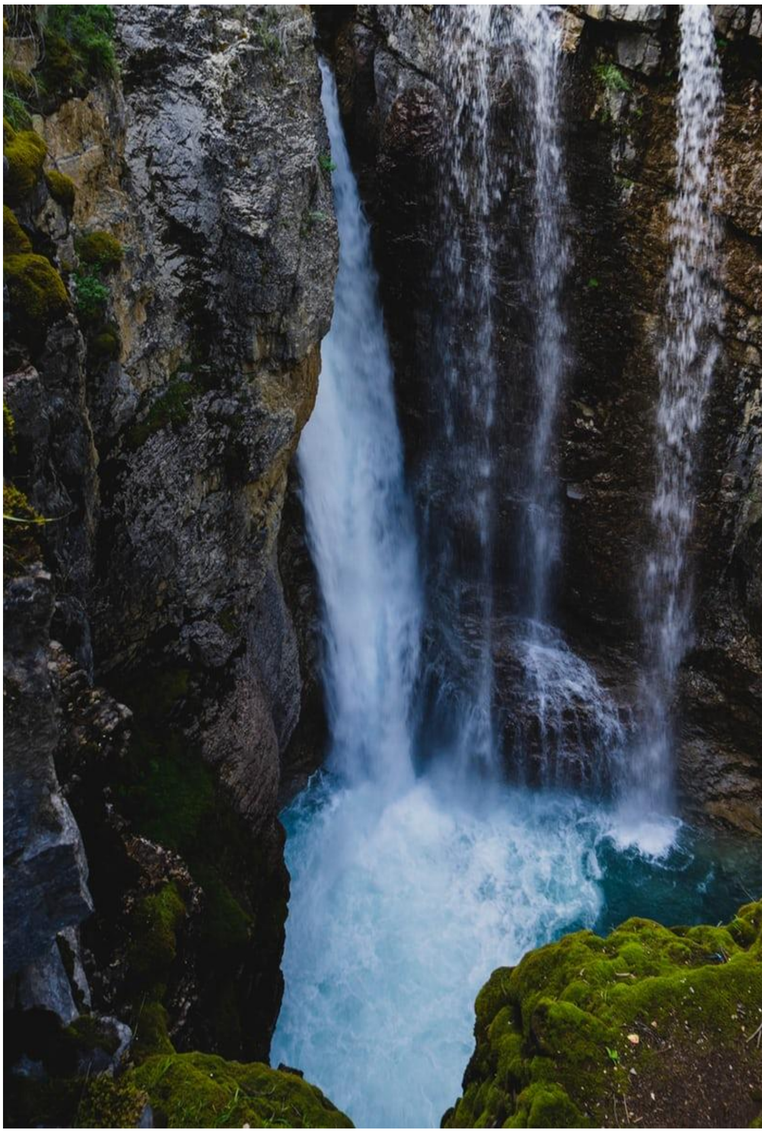
As we approach the end of October, still no clearer as to whether we will be in or out of the EU by the next publication of this newsletter, we thought it important to reflect on what the potential regulatory implications are, should Brexit actually happen.

Since we started on this journey back in June 2016, there has been significant concern and focus on post-Brexit planning. The industry has achieved a lot in the past three years, with new offices opening, new regulatory licences being obtained, and staff being hired or moved. Firms should be proud of these achievements.

Brexit provides UK regulators, particularly the FCA, with an opportunity to reconsider the regulatory framework. For the regulated business activities that will continue from the UK, the future of regulation is an important topic. There are a number of key considerations, including:

- What are the short term priorities for UK regulators post- Brexit?
- What are the key drivers and challenges that will impact the UK regulatory landscape post-Brexit?
- What are the emerging trends and areas of focus we expect to dominate the UK regulatory landscape?

We also briefly explore potential impacts and considerations for the European regulatory framework once the UK departs.



*“Rules, of course, are a crucial mechanism for delivering outcomes, **delivering outcomes** we want to see for consumers and for markets. But they can also be interpreted so rigidly as to become what’s often called a **box-ticking exercise**...any organisation that prioritises being within the rules over **doing the right thing** will not stand up to scrutiny for long.”*

Andrew Bailey, FCA Annual Public Meeting, June 2019

Navigating the Brexit Wave

The Future of Regulation: short term priorities

Regulators have been busy preparing for Brexit. The FCA had more than 450 people working on Brexit at one point[1]. We have identified a number of short term priorities, as the UK departs the European Union ("EU").

1. **Transitioning EU branches:** EU branches in the UK are awaiting 'landing slots', which will only be announced once Brexit has taken place. This leaves a significant level of work for impacted firms to still do. This includes ensuring they have:
   - Identified the additional UK rules applicable to them as a third country branch
   - Applied these requirements to their existing governance, policy, and controls frameworks
   - Reviewed any services provided to the branch by the headquartered bank, ensuring there is effective oversight of these activities from the UK (and these services comply with local UK requirements where appropriate)

2. **Transitioning of existing legislation:** The FCA needs to ensure existing legislation is transitioned effectively. This should extend beyond simply onshoring existing European requirements. There are a number of requirements, which came into force based on EU wide cost benefit analysis (e.g. the MiFID II mandatory trading obligation for shares). The FCA should ensure the implications of applying these requirements in a UK only context are considered before onshoring them. Firms should consider proactively providing feedback on areas of European regulation they feel will be difficult to transition into UK regulatory requirements.

   Work is ongoing to ensure UK specific data is available to firms, to enable them to meet their compliance obligations. For example, the FCA recently published an update on the MiFID transparency regime[2]. Reliance is still being placed on existing ESMA calculations (e.g. annual determinations for MiFID II equity transparency). This means all UK based firms will still have some work to do as the FCA starts to diverge from the European regulatory framework over the next couple of years.

3. **Guidance on upcoming EU regulatory initiatives:** While the political negotiations and stand-offs continue, upcoming EU regulatory changes still require implementation. UK regulators will need to rapidly communicate their expectations to the market, once Brexit happens. This includes whether the proposed EU regulatory texts should be adopted in full, in part, or not at all, particularly in respect of the Securities Financing Transaction Regulation.

[1] Andrew Bailey, *Speech at the Annual FCA Public Meeting,* 17 July 2019
[2] FCA, *Update to the supervisory statement on the operation of the MiFID transparency regime, 9* October 2019

Navigating the Brexit Wave

The Future of Regulation: key drivers and challenges

Key drivers and challenges likely to impact the UK regulatory landscape post-Brexit

Robustness of regulatory supervision

The ability of the FCA to effectively regulate all 60,000 firms (and growing) within its remit, with limited resources, will be critical to ensure the UK regulatory framework remains robust. This is not a Brexit issue, but there is a risk that regulators could react more aggressively through policy rather than supervision, without the European regulatory framework.

UK regulators will need to work closely with their European counterparts and continue information sharing under memoranda of understanding.

Incentives to de-regulate

Maintaining a competitive financial services centre in the UK should be an important priority for the UK government. There are a number of levers the government has to enable this, including taxation. Greater flexibility in the regulatory framework might be another. Regulators will need to balance this with the need to protect clients and markets. We expect to see more enforcement action against individuals than firms, particularly in the short term, but we do not anticipate regulatory expectations receding.

Continued global harmonisation

Whilst Brexit presents an opportunity to diverge the UK's regulatory framework from Europe, in practice the UK will still seek to comply with global standards. For example, standards set by the Basel Committee on Banking Supervision or the Financial Stability Board. In practice, across key G20 initiatives, the key difference will be in respect of the timing of when and how the UK adopts, not if.

Ensuring competitiveness of UK firms

There is a widely held view that the UK has exported significant amounts of regulation to the EU. For example, the UK adopted the Retail Distribution Review years before independent advice and inducement bans were written into MiFID II. The PRA and the FCA will need to balance financial stability and good conduct outcomes, respectively, with the competitiveness of UK financial institutions against their peers operating abroad.

Navigating the Brexit Wave

The Future of Regulation: focus areas

The UK regulatory framework is likely to continue down the current trajectory, which is focused on senior management accountability, measuring outcomes rather than compliance with rules, and achieving a robust culture of challenge. We have highlighted some of the key areas of focus below.

Governance and Accountability

We expect the focus going forward will be on individuals, in particular senior managers, the 'reasonable steps' they have taken to ensure effective oversight, and what the outcomes were. We expect to see more investigations of individuals, compared to firms.

- Individuals should ensure they know what they are accountable for. This includes activities that might be outsourced.
- Individuals need to have access to the right data. The right data translates to meaningful information, which can be interpreted and used for decision making, not an overload of Management Information.
- Firms should start to consider their governance frameworks from an ESG perspective.

Culture and Conduct

Firms have done significant work around culture and conduct. However, a number of challenges remain:

- Ensuring all individuals (and not just senior management) understand and live the values of the organisation.
- Ensuring individuals can navigate the interests of clients, the market, and shareholders as they conduct business.
- Recognising conduct risk goes beyond front office (e.g. to all control functions, operations, and technology teams). If these functions are viewing their responsibilities through a conduct risk lens, then operational resilience will be easier to achieve.
- Going beyond box-ticking. The culture of an organisation should be to challenge whether the right outcomes are being achieved for clients every day, consistently throughout the organisation, and not just whether rules are being complied with.

Financial Stability

With the transition of EU branches to third country branches in the UK, financial stability will likely be a key concern. The debate around requiring subsidiarisation could continue, particularly if there is increased volatility in markets post-Brexit.

Liquidity will be a concern, at least in the short term. The contingency plans set out in the FCA's recent policy statement for certain funds investing in illiquid assets could be tested soon rather than later.

Regulatory Perimeter

Anyone who has had to read, understand, and interpret the Perimeter Guidance has our sympathy. Simplifying the regulatory perimeter would provide greater clarity to both customers and firms. The problem is not limited to only financial services regulation. We feel there is a broader issue where firms declare in communications who their regulator is (professional services firms and the ICAEW is one example), when in reality only a portion of their business is reviewed, challenged, and actively monitored by a regulator (cross business conflicts aside).

Regulators should consider how to deal with general communications from firms stating they are regulated, without specifying for what, including whether further clarification in disclosures might be needed.

Navigating the Brexit Wave

The Future of Regulation: EU framework

The Future of the European Union Regulatory Framework

There are likely to be many ramifications for the European regulatory framework, after the UK's departure. Despite examples of input from other countries into EU regulatory initiatives, the UK, either through its regulators or its civil servants, has been a strong driver and contributor. The capital markets union roadmap, instigated by Jonathan Hill, is just one example.

- **Greater de-centralisation.** The chair of the AMF earlier this year called for more flexibility in the way countries implement 'market rules'[3]. There has been an increasing trend to issue more requirements as 'regulation', which does not require local transposition by member states, rather than 'directives', which do require transposition, over the past few years. Pressure from regulators, such as the AMF, could lead to a reversal in this trend. Greater flexibility in the implementation of market rules by member states could also impact the long term viability of the capital markets union project for the EU.

- **Approach to third country firms.** There has been some effort over the last few years to harmonise the third country regime across the EU bloc, such as through MiFID II. It is worth noting though that even when a third country is not considered 'equivalent' by ESMA, national regulators still have flexibility for bilateral negotiations with the relevant third country. This is no different to the regulatory landscape before MIFID II.

- **ESMA supervisory convergence programme.** ESMA has been running a detailed programme to ensure supervisory convergence across the European states for some time now. Whilst this work will continue to be important, there remain challenges due to the economic imbalances between the states – not all member state National Competent Authorities ("NCAs") have the same level of financial means to implement, supervise, and enforce. Furthermore, not all countries appear to have the same will to enforce all regulation with equal rigour.

  ESMA recently published the findings of a peer review on achieving data quality for EMIR. Of the six NCAs reviewed, it found only two (France and Ireland) that fully or broadly met the peer review's expectations across all six categories assessed[4]. The EMIR requirements have been in place since 2014 and the other four NCAs assessed included the FCA in the UK and BaFIN in Germany. The future of regulatory convergence for the EU after Brexit depends on the extent to which member states implement EU regulation – at some point, there has to be a trade off between the cost of drafting and negotiating requirements against the number of member states implementing these requirements.

[3]The Financial Times, *'French financial regulator wants more flexible market rules', 14* July 2019
[4]ESMA, *Final Report: Peer review into supervisory actions aiming at enhancing the quality of data reported under EMIR,* 17 October 2019

Navigating the Brexit Wave

The Future of Regulation: regulators and oversight

Whilst not directly related to Brexit, we anticipate the regulatory landscape in the UK will shift as a result of greater adoption of digital and innovation capabilities by the FCA. Those firms which have not been under the FCA's radar will, in time, face greater scrutiny.

The FCA regulates more than 60,000 firms in the UK. All of these firms will have been through some form of authorisation or approval process. For EU branches in the UK and those firms passporting, this may only have been a notification. However, the ongoing oversight and supervision of these firms varies and is risk based. This presents a number of challenges to the FCA in respect of overseeing firms which do not have a direct supervisor assigned. At times, this may also present a challenge to the firms impacted, who do not have a consistent point of contact.

The FCA is doing significant work in respect of digital and innovation. We feel that their adoption of digital solutions to extend their supervisory coverage will be critical to ensure their client conduct and market conduct objectives are achieved.

Level of FCA engagement with flexible firms[5]

72%
Culture
Flexible firms who have not seen any communication or had conversations with the FCA on the firm's culture

57%
Contact
Flexible firms have no email contact with the FCA at least once in a three month period

66%
Knowledge of rules
Flexible firms who feel FCA staff are knowledgeable about the FCA's rules and requirements (compared to 88% of fixed firms)

[5]FCA and Practitioner Panel, *2019 Annual Report*, July 2019

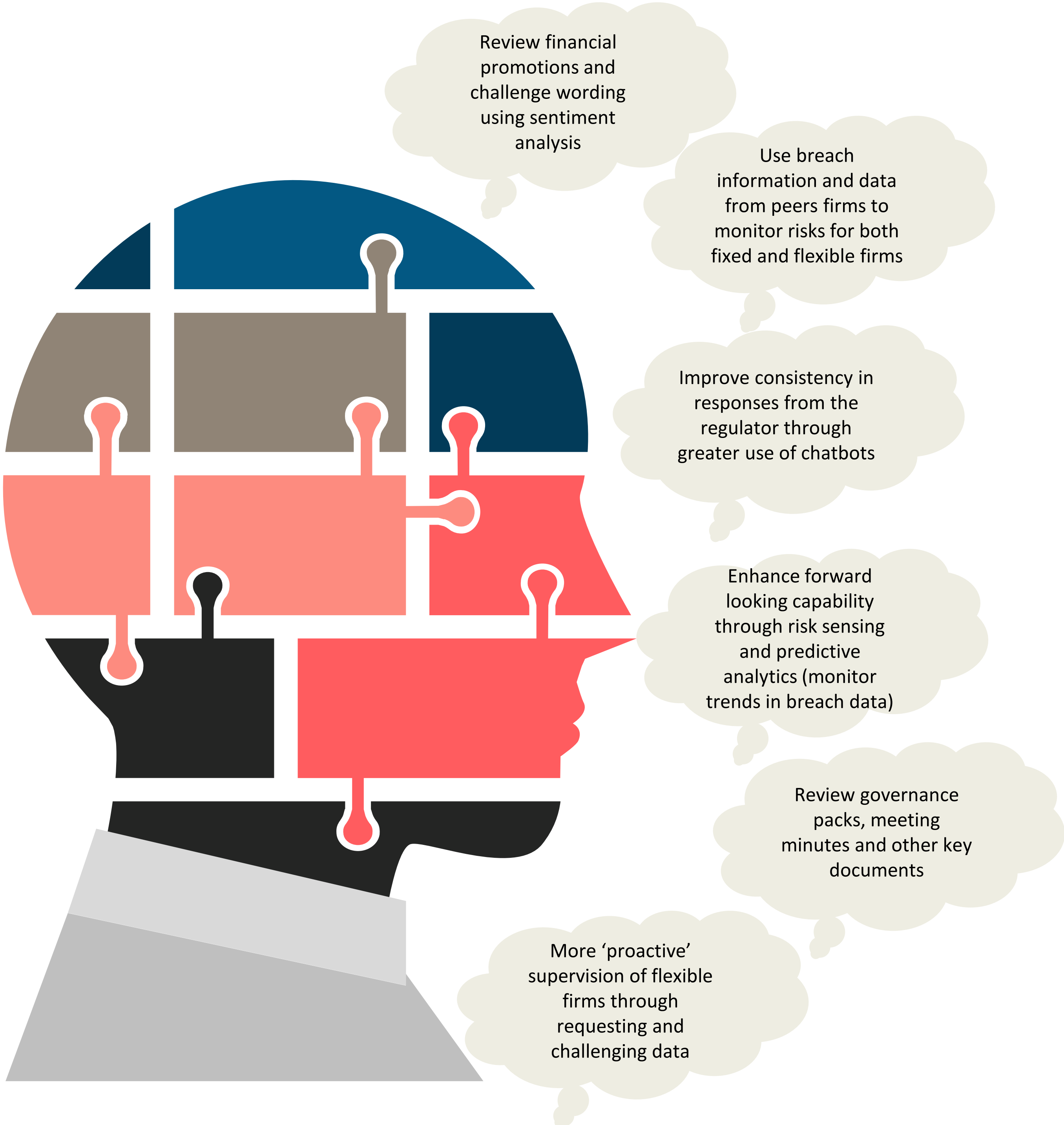
Navigating the Brexit Wave

The Future of Regulation: regulators and oversight

The Virtual Supervisor

A higher level of digital adoption by regulators could significantly shift the level of focus the majority of regulated firms have, forcing them to raise the regulatory bar. For example, virtual supervisors could be deployed to ensure there is sufficient coverage of regulated firms.

Regulators would need to balance the level of oversight. There is a risk that an overly interventionist approach could shift the first line of defence away from firms and to the regulator. If, or when, regulators start deploying virtual supervisors, it is important that the virtual supervisor remains a supervisor and is not treated as a line of control by firms.



Regulatory Radar

Summary of the News

Scanning the regulatory horizon can be a time consuming exercise. Each month, we will set out an extract of regulatory updates from our European Regulatory Oversight & Screening ("EROS") tool. There are a significant number of publications, as you would expect. The extract covers the month of September and has been arranged by taxonomy. The extracts in this section are limited to: FCA, PRA, ECB, EBA, ESMA, IOSCO, and FSB publications. This extract is not intended to be an exhaustive list or relied upon.

Key September highlights:

Data

The FCA announced in September that it has postponed its Call for Input to explore the access and use of data in wholesale markets, however the regulator remains committed to launching work in this area in the near future. Reports published by the Centre for Data Ethics and Innovation on ethical issues in AI are a perfect example of the importance of ethical data usage. Firms should be preparing now.

Financial Crime

Vicky Saporta, Executive Director at the PRA, wrote a 'Dear CEO' letter to draw attention on money laundering and terrorist financing risks, urging firms to:

- Ensure that managers have the right knowledge, skills, and experience to perform their duties
- Have robust governance arrangements
- Ensure that the FCA's senior management responsibility for financial crime is allocated to individuals of sufficient seniority to perform their role effectively

Liquidity

There have been a number of publications on liquidity, especially regarding the asset management industry:

- The FCA issued new rules for open-ended funds investing in illiquid assets (e.g. property)
- ESMA released two publications on liquidity stress testing for investment funds

Regulatory Radar

Summary of the News

Capital Markets
Asset and Wealth Management
Retail banking
Insurance

Basel III

The macroeconomic impact of changes in economic bank capital buffers

This article from the ECB attempts to answer the following question: *How do changes in capital requirements affect bank lending, lending spreads and the broader macroeconomy?*

Thinking beyond borders: how important are reciprocity arrangements for the use of sectoral capital buffers?

This article from the ECB explores the relevance of sectoral cross-border credit and analyses the effects of the implementation of mandatory reciprocity arrangements.

Clarification on the treatment of legacy instruments

The EBA announced its intention to provide clarity on the appropriate treatment of 'legacy instruments' at the end of the grandfathering period (2021). The aim of the clarification is to preserve a consistent and high quality capital base for EU institutions under the CRR.

Understanding sectoral countercyclical capital buffers

This article from the EBA discusses the application of countercyclical capital buffers.

Brexit

Updates to the FCA's directions under the Temporary Transitional Power (draft)

The TTP gives the FCA flexibility in applying post-Brexit rules, allowing firms to transition to a new framework. It would only come into effect on exit day if the UK leaves the EU without an implementation period.

FCA's survey on 400 companies on their preparations for EU withdrawal – 2019 Q3

- Most companies think they are "as ready as can be" for a no-deal Brexit.
- Companies who are not ready for a no-deal Brexit are generally more pessimistic about the outlook.

Andrew Bailey's speech on financial sector preparations for no deal Brexit

While preparations for the financial sector have advanced over 2019, there are still a number of issues and improvements to be made.

Cyber & Op. Resilience

Sector Simulation Exercise – SIMEX 2018 Report

Outcomes and high level findings following the 2018 cyber simulation exercise for the financial sector from the BoE.

Data & Ethics

Paper from the Centre for Data Ethics and Innovation on AI

The CDEI has published its first series of snapshot papers on issues of public concern in AI ethics including deepfakes, AI and insurance and smart speakers.

Financial Crime

'Dear CEO' letter on money laundering & terrorist financing

Letter from Vicky Saporta, Executive Director at the PRA, to support the EBA Opinion on money laundering and terrorist financing.

Governance & individual accountability

Strengthening individual accountability

Resolution assessments and reporting amendments from the PRA on strengthening individual accountability.

Unit-linked funds' governance review: findings and next steps

The FCA has reviewed firms' governance practices covering the value provided by unit-linked funds, and is considering whether it needs to change the rules.

Regulatory Radar

Summary of the News

- Capital Markets
- Asset and Wealth Management
- Retail banking
- Insurance

Liquidity

Illiquid assets and open-ended funds – FCA feedback

The FCA issued new rules applying to certain types of open-ended fund investing in inherently illiquid assets such as property.

Liquidity risk management for insurers – PRA

This supervisory statement states out the PRA's expectations concerning the liquidity risk management framework all UK Solvency II firms must have in place.

Stress simulations framework for investment funds

ESMA developed a framework to be used for stress simulations for the investment fund sector and published a case study applied to 6,000 UCITS bond funds.

ESMA strengthens liquidity stress tests for investment funds

ESMA published final guidance regarding liquidity stress tests of investment funds – applicable to both Alternative Investment Funds (AIFs) and Undertakings for the Collective Investment in Transferable Securities.

MiFID II

Multi-firm review of research unbundling reforms

FCA's findings of their review on how firms have implemented MiFID II rules since their introduction in January 2018.

MiFID II Report Review – ESMA

ESMA published responses to its consultation on cost of market data (pre- and post-trade data) and consolidated tape for equity instruments.

Cost & charges disclosure

ESMA published responses to its call for evidence on the impact of the inducements and costs and charges disclosure requirements under MiFID II.

Reporting

Guidelines for completing regulatory reports – PRA

PRA's expectations on how firms should submit supervisory reports under parts of the PRA Rulebook (Regulatory Reporting, Close Links, Change in Control).

Updates on the AnaCredit Reporting Manual – ECB

Main set of validation checks that will be performed in order to ensure that the quality of AnaCredit data is satisfactory.

Retail Conduct

Changes to mortgage reporting requirements

Policy statement from the FCA and the PRA.

Core competencies framework on investors' financial literacy

IOSCO publishes a framework to help members enhance investor education initiatives.

Mis-selling of financial products

IOSCO publishes a report on how members have implemented suitability standards aimed at preventing the mis-selling of complex financial products.

Solvency II

Solvency II: Own Funds – PRA

For firms assessing the quality of their existing own funds and/or intending to issue new own fund items under Solvency II.

Sustainable Finance & Climate Change

Importance of a sustainable financial system

Remarks by Mark Carney given during the UN Secretary General's Climate Action Summit 2019.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