Exchange – International

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DLA PIPER

Introduction

Welcome

DLA Piper's Financial Services International Regulatory team welcomes you to the 46th edition of Exchange – International, our international newsletter designed to keep you informed of regulatory developments in the financial services sector. This issue includes updates from the UK, the EU, as well as contributions from Ireland, Germany and the US, plus international developments.

With green-related issues being at the top of the regulators' and institutions' agenda, in this edition, In Focus analyses the new guidelines released by the Climate Financial Risk Forum, which aim to assist the financial sector in developing its approach to climate-related financial risks and opportunities.

In the UK, we look at the Financial Conduct Authority's Business Plan for 2021/22 and provide insights on the regulator's key priorities and objectives for the coming year. We also discuss the UK regulators' expectations regarding Diversity and Inclusion in the financial sector and how these affect firms' operations and governance. In addition, we examine how the FCA intends to tackle retail investor harm more generally and look more closely at its plans to strengthen financial promotions rules for high-risk investments, with a view to helping retail investors make more effective decisions.

In the EU, we discuss the digital euro project, which is being prepared by the European Central Bank. With a view to promoting its competitiveness as a location for investment funds, Germany has recently launched a new investment fund category of development promotion funds and we provide insights on this development. In addition, we look at Ireland's new rules concerning the cross-border distribution of investment funds.

In the US, we analyse the new guidance published by the New York State Department of Financial Services on addressing ransomware attacks, which highlights cybersecurity measures to significantly reduce the risk of an attack.

With regards to international developments, we look at the recent G7 public policy principles which set out the global standards for retail central bank digital currencies. Lastly, we provide insights on the Financial Stability Board's report on promoting climate-related disclosures, which builds on the relevant framework recommendations provided by the Task Force on Climate-related Financial Disclosures.

If you have any comments or suggestions for future issues, we welcome your feedback. The DLA Piper Financial Services Regulatory Team November 2021.

Contents

UK

FCA publishes Business Plan 2021/22

The FCA published its Business Plan for 2021/22 on 15 July, setting out its key priorities and objectives for the coming year.

The FCA refers to the world as being subject to "continual disruptive change" and rather unsurprisingly, the impact of and change brought about by the COVID-19 pandemic is a trend throughout the Business Plan.

In particular, the FCA notes that the way in which people access and use financial services, along with the structure of global wholesale markets, has significantly changed.

For example:

- The digitalisation of financial services has brought profound changes to the way consumers make decisions and how global markets operate.
- The transition to a net-zero economy will require an entirely different approach to markets and investment products in the UK and internationally.
- Persistently low interest rates may lead to consumers taking excessive financial risk or broader systemic risks in wholesale markets.

Unlike the 2020/21 Business Plan, the FCA has separated its priorities into those related to consumers, wholesale markets and cross-market and these are as follows:

FCA PRIORITIES 2021/22		
CONSUMER	WHOLESALE MARKETS	CROSS-MARKET
Enabling effective consumer investment decisions	Working to reinforce the effectiveness of the UK wholesale markets	Fraud strategy
Ensuring consumer credit markets work well	Non-bank finance	Financial resilience and resolution
Making payments safe and accessible	Tightening supervision and supervisory expectations of appointed representatives	Operational resilience
Delivering fair value in a digital age		Diversity and Inclusion
Improving consumer outcomes through the new Consumer Duty (which is currently under consultation)		Environmental, Social and Governance (ESG)
		International Cooperation
		Market Access, Equivalence and Trade Associations

DLA Piper comment:

There are some key themes which emerge from this Business Plan which are:

A FOCUS ON ENFORCEMENT

The FCA wants to get "more assertive – testing the limits of our own powers and engaging with partners to make sure they bring their powers to bear." The FCA wants to be seen as more aggressive, and no doubt this will likely manifest in greater scrutiny of firms and a desire to make a very public example of poor practices.

The FCA is prepared to take greater risk when making enforcement decisions and will be consulting on changing the balance of decision-making taken by the FCA Executive and the Regulatory Decisions Committee, with the FCA expecting to intervene more often.

To detect misconduct and intervene early, the FCA intends to "take advantage of data and technology." The FCA is investing over GBP120 million over three years to deliver its "data strategy," which will include better data collection (including publicly available information and "web scaping") and analytics to better monitor firms.

In general, the FCA expects the following areas to remain particularly susceptible to greater scrutiny: fraud, financial resilience, operational resilience and financial promotions (with intervention in breaches of the latter being fast-tracked).

In the retail sector, interventions are likely to target investments, consumer credit, payments and digital products/services; while In the wholesale sector, interventions are likely to target non-bank finance (such as funds and asset managers) and appointed representatives.

Finally, the FCA plans to continue its "targeted litigation strategy" to bring greater clarity to consumers and will engage with partners so they can intervene where the FCA cannot.

While the FCA favours preventative measures over enforcement, it recognises the need for strict enforcement measures to prevent consumer harm at the earliest opportunity. Firms should heed the commentary in the Business Plan and act as necessary to avoid FCA intervention.

PROMOTION OF COMPETITION

The FCA wants to continue to promote competition and innovation in the interests of consumers and to ensure market integrity.

The FCA is keen to continue intervening on competition issues and the FCA notes its recent work in tackling the "loyalty penalty in insurance" as an example of evidence-based change to improve consumer outcomes. The FCA also wants, under the Consumer Duty proposals, to ensure that the price of products and services represent "fair value" for consumers. Firms remain unsure and concerned about how this potential pincer movement will work in practice, and this is certainly something to watch.

With regards to wholesale markets, the FCA notes that consumer protection partly relies on firms in these markets meeting the components of market integrity set out in FSMA, and one of the FCA's priorities is to overhaul the listing and prospectus rules framework. It will be interesting to monitor how the FCA will strike the right balance between good quality listings and yet permitting the likes of the London Stock Exchange to thrive in the context of global competition for listings.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Supporting the government in its pursuit to help the UK achieve a net-zero economy by 2050 is a key priority of the FCA.

In addition to slightly more general objectives to achieve this, such as encouraging innovation in sustainable finance, there is a particular focus on fund managers and their products meeting ESG expectations. The FCA states that it will increase its supervision of firms and particularly whether ESG attributes of asset managers' investment products are fair, clear and not misleading. This should be noted by fund managers in particular.

CONTINUING THE CONSUMER CREDIT CLAMP DOWN

Consumer credit remains a high-risk area for the FCA. The pandemic has only served to heighten this with the FCA stating that "the pandemic has also caused financial difficulties for many consumers, increasing the risk they will take on credit at interest rates that will be unaffordable in the medium to longer term."

The Business Plan emphasises the FCA's intention to use its supervisory role to prevent against market harms such as:

- Undertaking a "use it or lose it" exercise piloting the removal of firms' permissions where they are not carrying out regulated activities. This is to limit the "halo effect" of regulation, where firms use the FCA's oversight of one activity to make unregulated activities appear more trustworthy.
- Exercising stronger oversight of newly authorised firms ("a regulatory 'nursery'"). The FCA acknowledges that its approval is based on firms' business plans, which can evolve significantly in the early stages. Therefore, the FCA proposes to oversee these firms to check they comply with the FCA's rules and to identify potential harm early.
- Exercising stronger oversight of firms which are growing significantly, in line with the Chancellor's announcement on the Kalifa Review's recommendation, for a "Regulatory Scalebox." This will help newly authorised firms with plans to scale fast to receive support and oversight. A smart compliance culture and sound governance improve firms' operational resilience and enable them to scale sustainably.

Furthermore, as signposted by the Woolard Review the FCA focus for consumer credit will be outcomes focussed. In particular, forbearance and customer debt, vulnerability, access to appropriate products and digitalisation of the markets are emphasised.

The FCA now refers to "buy-now-pay-later" as deferred payment credit and reminds firms that this will be a core part of its focus, in partnership with the Treasury.

Firms should read the Business Plan as a marker that "tick-box" approaches to compliance are unlikely to suffice in consumer credit markets, as well as more broadly.

PAYMENTS, E-MONEY AND CRYPTO

End user protection and access to different payment tools are emphasised for payments and e-money.

As the payment services sector continues to develop rapidly and the payments market sees the impact of the continuing growth of Cryptoasets, the FCA is working closely with the Treasury and the Bank of England to develop a regime that encourages innovation while protecting payment services customers.

While from a perimeter perspective, there has been discussion about regulatory overlaps and distinctions between payments, e-money and crypto, it is noteworthy that the FCA views crypto as an important part of its payments work.

We have set out a summary of the FCA's priorities as follows for information.

Consumer Priorities

The FCA's consumer priorities for the coming year are set out below. While these mirror the 2020/21 priorities, the shape and scope of some of these have changed to reflect consumers' changing finances and behaviours.

ENABLING EFFECTIVE CONSUMER INVESTMENT DECISIONS

The FCA wants to reduce the harm to consumers from unsuitable advice and inappropriately risky investments (the FCA identifies Cryptoassets as a "very high-risk investment"). To achieve this, the FCA will among others:

- publish a three year "Consumer Investments Strategy" in the coming months, which will explain how the FCA will tackle firms and individuals who cause consumer harm;
- consult on the FCA's proposed changes to the financial promotion rules taking into consideration feedback received from its recent discussion paper on this;
- work to improve pension advice to ensure customers who have lost valuable benefits following unsuitable advice know how to get redress; and
- create a "consumer investment coordination group" with the Financial Services Compensation Scheme (FSCS), the Financial Ombudsman Service (FOS) and the Money and Pension Service.

ENSURING CONSUMER CREDIT MARKETS WORK WELL

As signposted by the Woolard Review, the FCA focus for consumer credit will be outcomes focussed. In particular, forbearance and customer debt, vulnerability, access to appropriate products and digitalisation of the markets are emphasised.

The FCA now refers to "buy-now-pay-later" as deferred payment credit and reminds firms that this will be a core part of its focus, in partnership with HM Treasury.

Firms should read the plan as a marker that "tick-box" approaches to compliance are unlikely to suffice in consumer credit markets as well as more broadly. Credit information, overdrafts and high cost credit are also called out.

The FCA wants to ensure that the consumer credit market can meet the continuing and changing demands for credit in a sustainable way; that consumers can access affordable products and make informed decisions; and that firms treat customers fairly, including if they fall into financial difficulty.

MAKING PAYMENTS AND E-MONEY SAFE AND ACCESSIBLE

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DELIVERING FAIR VALUE IN A DIGITAL AGE

The FCA wants consumers to be confident that they are getting fair value and can make informed choices about the products and services they use, and the FCA expects firms to deliver this by providing products and services of suitable quality and price.

The key areas of focus for the FCA are General insurance pricing practices, Digital competition and Investigating harmful business practices.

IMPROVE CONSUMER OUTCOMES THROUGH THE NEW CONSUMER DUTY (WHICH IS CURRENTLY UNDER CONSULTATION)

The FCA is consulting on proposals for a Consumer Duty in the retail market to set clearer and higher standards for firms' culture and conduct. The Consumer Duty will be in the form of a new Principle, supported by a set of cross-cutting rules and guidance focused around four key outcomes.

By introducing the proposed new Consumer Duty, the FCA wants firms to consistently place their customers' interests first and intends that it will give firms more certainty about the FCA's and consumers' expectations of the standards they should meet.

Wholesale Markets Priorities

Wholesale markets play a vital role in the UK economy, consequently, the FCA's priorities in this area focuses on market integrity which in turn should foster confidence, trust and a good level of participation in these markets.

- Work to reinforce the effectiveness of the UK wholesale markets

- Non-bank finance: the FCA wants to ensure that investors are offered products that are fair value, meet their investment needs and offer appropriate levels of protection
- Tightening supervision and supervisory expectations of Appointed Representatives (ARs)

Cross-Market Priorities

- Fraud Strategy
- International Cooperation
- Financial Resilience and Resolution

The FCA wants:

- to have appropriate capital, liquidity and reserves to cover outstanding liabilities;
- firms to hold financial resources proportionate to the potential harm caused if they do fail;
- to be better aware of those firms that are likely to fail so that they can work with the firm to reduce the harm from their failure; and
- those firms that do fail, to do so in an orderly manner.

OPERATIONAL RESILIENCE

The FCA expects firms to be operationally resilient against multiple forms of disruption (including global pandemics) to minimise the harm caused to consumers and markets. To that end, the FCA expects firms to implement the requirements set out in its Policy Statement published in March 2021 and will monitor this implementation during 2021/22.

DIVERSITY AND INCLUSION

Diversity and inclusion within firms and among consumers remains a key priority of the FCA with the FCA stating that "firms that represent the society they serve support the design of the financial services and products that improve consumer outcomes."

The FCA will continue to publish key indicators of diversity, the pay gap and progress against the FCA's ethnicity action plan. It will also develop how the FCA measures progress to ensure a consistent approach is taken to diversity and inclusion across financial services.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Financial services and markets have a central role in the transition to a low carbon economy and a more sustainable future. The FCA will support the government in this pursuit and to helping the UK to achieve a net-zero economy by 2020 by adapting the regulatory framework as necessary.

MARKET ACCESS, EQUIVALENCE AND TRADE ASSOCIATIONS

The FCA will support the government as it develops mechanisms to enable cross-border market access in financial services.

Among others, the FCA will provide technical advice on Free Trade Agreement negotiations and on negotiations for a Mutual Recognition Agreement on financial services with Switzerland. The FCA will also continue to engage with the Treasury on the Financial Services Act and on its "Call for Evidence" on the UK's overseas framework.

UK Government response to Payments Landscape Review

On 11 October 2021, HM Treasury published the UK government's response (Response) to its Call for Evidence to the Payments Landscape Review (Review).

The Response set out the UK government's plans in four priority areas:

- strengthening consumer protections within Faster Payments;
- unlocking the future of Open Banking enabled payments;
- enhancing cross-border payments; and
- future-proofing the regulatory and legislative framework that governs payments.

The call for evidence

The Review was launched in July 2020. The objective of the UK government is to ensure that the UK continues to be an early adopter and facilitator of payments technology while at the same time ensuring that payments are safe and that payment systems are resilient and stable.

Underpinning this objective are the following four high-level aims:

- That the UK payment networks operate for the benefit of end users, including consumers;
- That the UK payments industry promotes and develops new and existing payment networks;
- That UK payment networks facilitate competition by permitting open access to participants or potential participations on reasonable commercial terms; and
- That UK payment systems are stable, reliable and efficient.

To meet this objective, the UK government published the Review and sought evidence from the industry on its proposed actions. The Review received 68 responses which are summarised in Annex A of the Response.

Government response

In the Response, HM Treasury noted that the UK government is, in the post-Brexit context, committed to evolving its legislative framework and regulatory environment to create the conditions for the UK to maintain its status as a country at the cutting edge of payments technology while ensuring protection, resilience and stability.

In the Response, HM Treasury outlines the four priority areas for action by the government, UK regulators and the payments industry. These are as follows.

Faster payments

The UK government's view is that changes are needed to ensure the right level of protection for consumers using Faster Payments to address what happens when a payment goes wrong and equip Faster Payments for the future. New scheme rules are required which set out reimbursement and liability requirements of all scheme members to prevent authorised push payment scams. The UK government is engaging with the Payment Systems Regulator (PSR) on next steps.

The UK government expects Pay.UK, the Open Banking Implementation Entity (OBIE), and Faster Payments participants to reduce the level of harm to consumers both through preventative measures and reimbursement. The UK government does not rule out further regulation but cites the success of Confirmation of Payee as an example of positive industry action.

Open banking

The UK government wants to see the Open Banking initiative being used to facilitate further account to account payment transactions in a secure manner.

The Response notes that debit and credit cards are dominant payment method in shops and online. While there has been considerable innovation in payments services, these innovations have tended to rely on cards – for example, enabling payments to be made by cards held in digital wallets and card processing making it easier for businesses to accept card payments.

Giving consumers the option to use account to account transactions would create competition and choice between payment networks, enable fintech propositions and provide cheaper and more tailored payments to merchants and consumers alike.

Such transactions are already happening. For example, HM Revenue and Customs is already harnessing Open Banking enabled payments to allow taxpayers to submit payments directly from their bank accounts, rather than through a debit or credit card.

The UK government has committed to looking at what changes are required to the Faster Payments infrastructure to support real-time account to account transactions. The UK government notes that the Competition and Markets Authority (CMA) has already set out the final steps of the implementation phase of Open Banking including in terms of what it needs to support reverse payments such as refunds and for variable recurring payments such as regular purchases from the same merchant.

Enhancing cross-border payments

The UK government has an ambition for the UK to be an open and global financial hub in which people and businesses can make and receive cross-border payments seamlessly, quickly and cheaply, whether it is to or from family or friends, or when trading, buying or selling goods and services across borders.

In the Response, the UK government welcomed the ambitious implementation proposes of the G20 in its roadmap as well as the Financial Stability Board's targets for addressing the challenges of cross-border payments (namely their cost, speed, access and transparency). For example, the quantitative targets of the FSB include that 75% of global retail payments must result in funds being available to the recipient within one hour of the initiation of the payment by the end of 2027.

In the Response, the UK government acknowledged that to meet these targets, it will be necessary for central banks and industry to make all necessary investments to update legacy infrastructure and adopt new standards.

Future-Proofing the legislative and regulatory framework for payments

In the Response, the UK government states that it will transfer responsibility for firm-facing requirements in areas of retained EU financial services law to the regulators. The UK government expects this will include retained EU payment services law. To this extent, the UK government is seemingly prepared to delegate more responsibility for the regulation of payment services and electronic money away from Parliament to UK regulators such as the Financial Conduct Authority. The UK government notes that legislation is typically less easy to flex than regulatory rules to respond to the changing payments landscape.

The UK government is also proposing to consult on bringing systematically important firms in payments chains into the Bank of England's regulation and supervision in the first half of 2022.

In addition to the above new developments, the UK government in the Response refers to existing consultations and proposals including:

- the UK government consultation on extending the Senior Managers and Certification Regime to Financial Market Infrastructures supervised by the Bank of England;
- the UK government consultation on proposals to ensure the UK's regulatory framework is equipped to harness the benefits of new forms of digital money, so-called stablecoins, supporting innovation and competition, while mitigating risks to consumers and stability; and
- HM Treasury and the Bank of England's Central Bank Digital Currency Taskforce.

GBP10 billion raised in inaugural UK green gilt issuance

On 23 September 2021, the UK government's GBP10 billion inaugural green gilt (bond) was listed on the Sustainable Bond Market of the London Stock Exchange (LSE). In addition to being the largest sovereign green bond to list on the LSE, it is also the largest inaugural sovereign issuance to date.

Inaugural UK green gilt

This 12-year bond, maturing on 31 July 2033, was the first issuance of the UK government's Green Financing Programme and is part of a commitment to issue two green gilts in 2021. The UK will issue a second green gilt this October with the aim of raising at least GBP15 billion in the 2021-22 financial year.

Green expenditures

Proceeds from the green gilts will be allocated to projects that meet the environmental eligibility criteria set out in the Green Financing Framework. Specifically, they will be used to fund the UK government's spending in six key categories:

- renewable energy
- clean transportation
- energy efficiency
- living and natural resources
- climate change adaptation
- pollution prevention and control

HM Treasury will publish reports on the allocation of the proceeds to each category and on the environmental impacts and social benefits of eligible green expenditures.

Retail green savings bonds

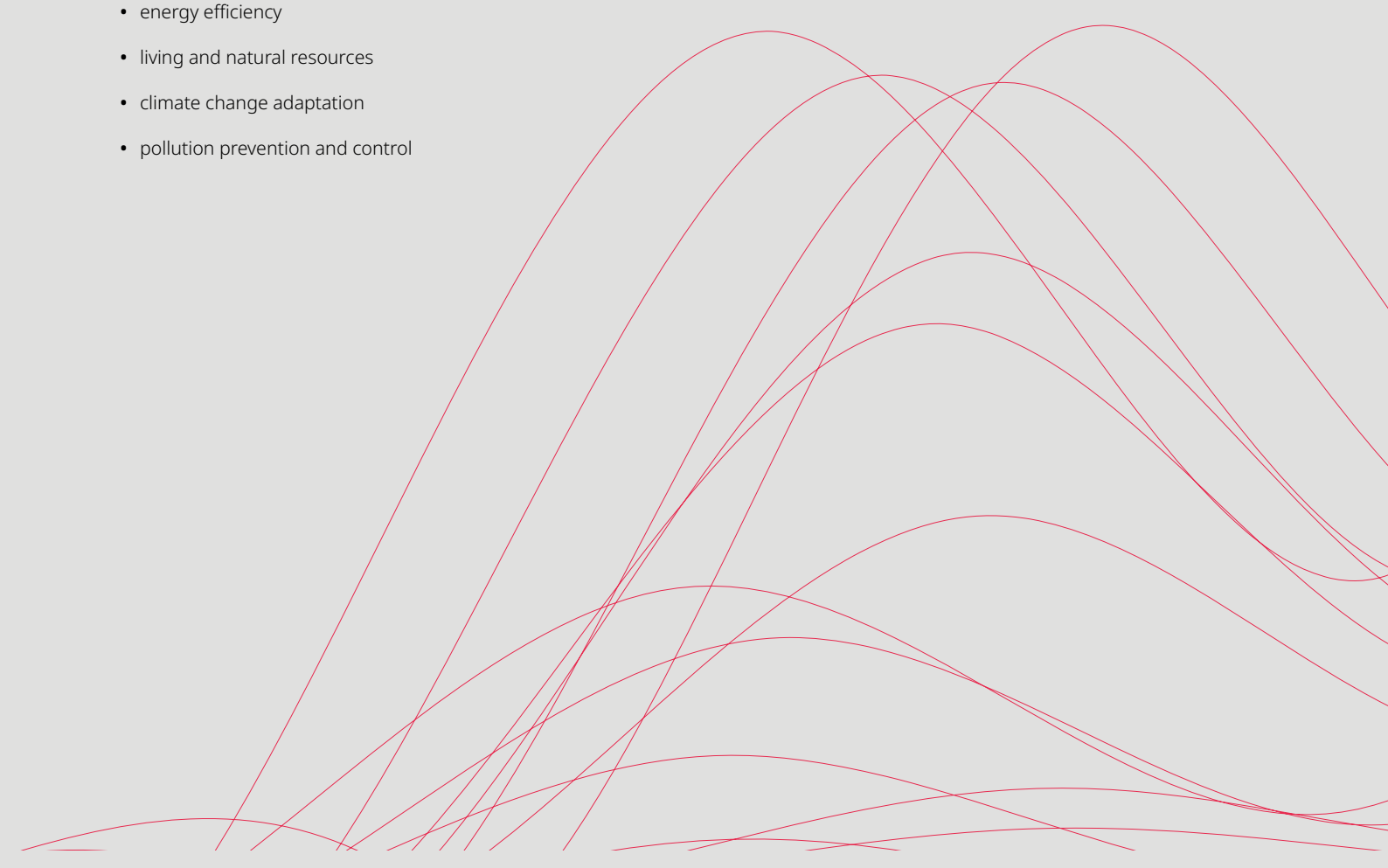
The UK is also planning to issue retail Green Savings Bonds later this year through the state-owned National Savings & Investments Bank. These bonds will be the first standalone retail product to be tied to a sovereign green bond.

Green finance

Green finance is expected to play a critical role in combating climate change and other environmental challenges by raising capital for the effort to build a sustainable net zero UK economy as well as funding innovation and job creation in green industries.

The UK government's Green Financing Framework sets the standard for corporate and sub-sovereign sterling ESG bonds.

The listing of these green gilts reaffirms London as the world's leading hub for green finance.



FCA plan to tackle retail investor harm

On 15 September 2021, the Financial Conduct Authority (FCA) published a new strategy which is designed to ensure UK consumers can invest with confidence by understanding the risks they are taking and what the regulatory protections apply (Strategy).

While the FCA note that it does not restrict consumer choice, the Strategy does propose a number of measures which aim to allow consumers to access and identify investments that suit their investment objectives and their access to risk.

Consumer harm

In the Strategy, the FCA identifies a number of areas of significant consumer harm:

- Consumers are losing significant sums of money to investment fraud and scams. 23,378 consumers reported they lost an estimated GBP569 million to investment fraud from April 2020 to March 2021 – an almost threefold increase since 2018.
- Consumers are looking for help in avoiding scams or dealing with their consequences. The number of calls the FCA has received from consumers on scams has doubled since 2016/17.
- Many consumers who might gain from investing currently hold their savings in cash. There are 15.6 million UK adults with investible assets of GBP10,000 or more. Of these, 37% hold their assets entirely in cash, and a further 18% hold more than 75% in cash. Over time, these consumers are at risk of having the purchasing power of their money eroded by inflation.
- Other consumers are investing in higher risk investments, many without realising the risks. 6% of adults increased their holdings of higher risk investments during the pandemic. Yet research conducted for the FCA revealed that there is a lack of awareness of the risks associated with investing, with 45% of non-advised investors failing to recognise that "losing some money" was a risk of investing.
- The characteristics of investors are changing, as well as the way they invest. Younger people are twice as likely to have invested in higher risk investments than adults overall. For example, 44% of cryptocurrencies and 31% of crowdfunding investments are held by people under 34.
- Financial advice is not reaching all parts of the market. Half of UK adults with GBP10,000 or more of investible assets (around 8.4 million people) did not receive any formal support to help them make investment decisions over the last 12 months. Only 8% of UK adults received financial advice and only 1.3% of adults made use of online robo-advice.

Objectives of the Strategy

By 2025, the FCA will:

- reduce by 20% the number of consumers who could benefit from investment earnings but are missing out. There are nearly 8.6 million consumers holding more than GBP10,000 of investible assets in cash;
- halve the number of consumers who are investing in higher risk products that are not aligned to their needs. 6% of consumers increased their holdings of higher risk investments during the pandemic, with 45% of self-directed investors saying they did not realise the risks;
- reduce the money consumers lose to investment scams perpetrated or facilitated by regulated firms. Consumers lost nearly GBP570 million to investment fraud in 2020/21 – this has tripled since 2018; and
- stabilise the GBP833 million compensation bill for the Financial Services Compensation Scheme, and target a year-on-year reduction in the Life Distribution and Investment Intermediation (LDII) and investment provision funding classes from 2025 to 2030.

Package of measures

To achieve objectives of the Strategy, the FCA has set out a package of new measures including:

- exploring regulatory changes to make it easier for firms to provide more help to consumers who want to invest in relatively straightforward products;
- launching a new GBP11 million investment harm campaign, to help consumers make better-informed investment decisions and to reduce the number of people investing in inappropriate high-risk investments;
- being more assertive and agile in how the FCA detects, disrupts and takes action against scammers, thereby reducing investment scams;

- strengthening the Appointed Representatives (AR) regime, with a consultation to be launched later this year, which aims to raise the quality of financial advice;
- strengthening the financial promotions regime in three areas; the classification of high-risk investments, further segmenting the high-risk market and strengthening the requirements on firms when they approve financial promotions; and
- reviewing the compensation framework to ensure that it remains proportionate and appropriate, particularly where firms fail, leaving behind compensation liabilities for the FSCS to address. This will reduce the cost and impact of poor advice.

Consumer Investments Data Review

Alongside the Strategy, the FCA also published a Consumer Investment Data Review which shows that between 1 April 2020 and 31 March 2021, the FCA's work to tackle harm, included:

- stopping 48 new firms from entering the market where the FCA identified potential for consumer harm (representing 1 in 5 applications);
- opening over 1,700 supervisory cases involving scams or higher risk investments; and
- publishing over 1,300 consumer alerts about unauthorised firms and individuals.

Speech by the FCA Chair on the Risks of Online Cryptoasset Promotions

On 6 September 2021 Charles Randell, the Chair of the Financial Conduct Authority (FCA) and Payment Systems Regulator, gave a speech to the Cambridge International Symposium on Economic Crime about the risks of token regulation.

In the wide-ranging speech, the Chair commented on cryptoasset scams, the role of the FCA in combatting financial crime online and the need for new legislation and FCA powers to address consumer harms associated with online paid-for cryptoasset promotions and scams.

Cryptoasset promotions and scams

The Chair noted that a Kim Kardashian post where she asked her 250 million Instagram followers to speculate on tokens by "joining the Ethereum Max Community" may have been the financial promotion with the single biggest audience reach in history.

While Kim Kardashian did disclose that her post was an advertisement, she did not disclose that Ethereum Max – not to be confused with Ethereum – was a speculative digital token created a month before by unknown developers. The Chair did not express a view as to whether Ethereum Max was a scam, but he did state that social media influencers are now routinely paid by scammers to help them pump and dump new tokens on the back of pure speculation. Some influencers promote tokens that turn out not to exist at all.

This type of hype creates a powerful fear of missing out from some consumers, who may have little understanding of the risks. Despite the FCA's warnings, around 2.3 million Britons currently hold a speculative token. According to research undertaken by the FCA, around a quarter of a million people mistakenly believe that they will be protected by the FCA or the Financial Services Compensation Scheme if the investment goes wrong.

The FCA's current role

The FCA's current role is limited to registering UK-based cryptoasset exchanges for anti-money laundering purposes. According to the Chair, some businesses have applied for registration but have fallen short of the acceptable standards, so have had to withdraw their applications.

While the Chair did not mention it expressly, the FCA has recently warned consumers that Binance Markets Limited is not registered or permitted to undertake any regulated activity in the UK. Binance has recently complied with the requirements of an FCA's Supervisory Notice including via an online clarification.

The FCA has also published guidance on which tokens are within the UK regulatory perimeter, banned the sale of crypto-derivatives to retail consumers and published a list of unregulated crypto exchanges that the FCA suspects are operating in the UK.

The FCA does not, however, have a remit from Parliament to regulate the issue or promotion of speculative tokens that are outside the current scope of the regulatory perimeter.

The Chair did note that bringing these tokens within scope could have unintended consequences such as making investors think these are good faith investments (a "halo-effect"). The FCA does not regulate other highly speculative assets like art, foreign currencies or commodities like gold.

Any effective system of regulation would require a business seeking registration or authorisation by the FCA to be firmly within the FCA's reach – including having sufficient people and resources in the UK. Given the decentralised, online and cross-border nature of speculative tokens, this may not be the most effective way of addressing consumer harm.

New legislation to hold gatekeepers accountable

The Chair noted that Google has committed to stop promoting advertisements for financial products unless an FCA authorised firm has cleared them. According to the Chair, it is now time for other websites – Facebook, Microsoft, Twitter, TikTok – to do the right thing too. In his view, legislation is needed to address these harms.

The UK government's proposed legislation about online harm now includes some financial harms but paid-for online advertising remains out-of-scope. The Chair said this should be included in-scope of the Online Safety Bill.

According to the Chair, legislators need to consider three issues:

- how to make it harder for digital tokens to be used for financial crime;
- how to support useful innovation; and
- the extent to which consumers should be free to buy unregulated, purely speculative tokens and to take responsibility for their decisions to do so.

Additional FCA powers

In the meantime, the Chair identified two areas where the FCA should have new powers to take action to reduce the potential harm to consumers from purely speculative tokens.

The first is to address online cryptoasset promotions. Her Majesty's Treasury has recently been consulting on the case for the regulation of some cryptoasset promotions. According to the Chair, it is absolutely imperative that any regulation of cryptoasset promotions require risks to be clearly highlighted and ensure that they do not give the impression that the token itself is subject to regulatory supervision and/or approval. Since these promotions are nearly all online and often made by promoters in other jurisdictions, the Chair also considered it imperative that any regulations in this area cover paid-for advertising on online platforms.

The second is to limit the risk of contagion from the unregulated activities of digital tokens to the regulated business of authorised firms. The Basel Committee is consulting on a proposal which would ensure that speculative digital tokens attract a full capital charge for banks. According to the Chair, it is important that all FCA authorised firms (not just banks) show how they address the risks from any digital tokens involved in their business: both in respect to their conduct risk and their prudential soundness.

The need for balance

The Chair concluded by acknowledging that any new legislation must not impede the development of the promising use cases for the technology that underlies certain tokens to flourish – especially the potential to make payments and financial infrastructures more efficient and accessible.

It is essential that policy makers find the right balance between protecting consumers/markets and encouraging useful new ideas in this area.

Those new ideas include the use of digital tokens as a means of payment (so-called stablecoins), security tokens providing a feasible alternative to more traditional investments and distributed ledger technology which has the potential to make settlement and custody more efficient.

Non-Fungible Tokens: What are the legal risks?

The market for Non-Fungible Tokens (NFTs) has boomed over the past year. Businesses and asset owners have been creating and selling NFTs representing a range of assets, whether digital or physical, including internet memes, digital images, event tickets and memorabilia.

Notable examples include the sale of an NFT representing the original source code for the World Wide Web, written by Tim Berners-Lee, the Web's inventor, for USD5.4 million, and the first tweet of Twitter's CEO, Jack Dorsey, for USD2.9 million.

This article sets out some of the key legal risks to be aware of for those thinking of investing in NFTs.

What is an NFT?

An NFT is a cryptographic tool which is capable of proving ownership and authenticity of an underlying asset, typically in digital form. Similarly to their cryptocurrency counterparts, such as bitcoin, NFTs are created (or "minted") and recorded using blockchain technology. Digital asset and blockchain platforms, such as DLA Piper's digital asset creation platform, TOKO, can be used to create NFTs. Those NFTs can then be bought and sold on marketplaces that are linked to the underlying blockchain technology.

A fundamental distinction between NFTs and cryptocurrency lies in the fact that NFTs are (as their name states) not "fungible," meaning each NFT is unique and therefore not interchangeable with any other NFT. Each NFT contains a unique identification and metadata that makes it a one-of-a-kind asset.

The growing interest in NFTs is further driven by the potential for creating new revenue streams. NFTs, and the blockchain technology on which they are founded, offer asset owners the opportunity to generate significant revenues in a new and innovative way, for example, by creating and selling fractions of assets as digital representations. Assets which would have previously proved difficult, if not impossible, to sell, such as the tweets or the source code referred to above, can be monetised through issuing NFTs. Asset owners can even sell an NFT in respect of the digital representation of a physical asset, while still owning (or separately selling) the underlying asset at the same time.

However, as with any asset class, it is important that investors consider the risks as well as the potential rewards.

Key legal risks of NFTs

DEFINING OWNERSHIP RIGHTS

As with any other contract of sale, it is crucial that a purchaser of an NFT carefully considers the terms governing the relevant token prior to purchase, including what rights are being acquired and what rights will remain with the seller. While the purchaser of an NFT buys, and then owns, the token, owning an NFT does not equate to owning the underlying asset itself. As such, the purchaser of an NFT will not necessarily enjoy rights such as copyright of the underlying asset, which often remains with the creator of the NFT.

Smart contract technology can be embedded into NFTs – for example, to prohibit the transfer of the NFT until certain conditions are met or to protect the minter's rights to royalties such that, each time the NFT is resold, the minter automatically receives a royalty fee. It is therefore crucial for investors to understand the mechanics of the NFT(s) in which they are interested in investing in advance of purchase.

Equally, sellers of NFTs should remain alive to the risk of being accused of misrepresentation when selling NFTs. Sellers should therefore make the terms of a sale clear, paying particular attention where matters such as the history of ownership or storage of the physical asset are of vital importance (for instance, in respect of a luxury good or work of art).

NFT owners also need to heed the usual warnings regarding market volatility, particularly given that NFTs are a relatively new asset class without a proven track record. It is important for investors not to get carried away by temporary market sentiments, to be aware of their own investment objectives, and to consider carefully the true value of any NFT they intend to purchase. In August 2021, for example, an NFT representing the clip art of a rock sold for 400 Ether, which equates to approximately USD1.3 million. This NFT was issued by EtherRock on the Ethereum blockchain. According to EtherRock's own website, "these virtual rocks serve NO PURPOSE beyond being able to be bought and sold, and giving you a strong sense of pride in being an owner of 1 of the only 100 rocks in the game :)."

Loss of or damage to the physical asset

An NFT and the underlying asset it represents are separate assets. While the NFT will contain information about its link to the underlying asset and the NFT holder's title to the NFT, should the underlying asset be destroyed, lost or stolen, the NFT could be rendered worthless. That said, an NFT representing artwork by the UK artist Banksy was marketed on the basis that the underlying artwork had been deliberately destroyed, leaving only the digital representation sold through the NFT. Therefore, in some instances, the destruction of the underlying physical asset, leaving only the NFT as evidence of its former existence, may serve to increase the value of the NFT.

It is nevertheless important to ensure (in some cases) that there is some guarantee as to the safety of the underlying physical asset and allocation of risk in the contractual documentation before purchasing an NFT.

Risk of fraud

While NFTs exist to authenticate provenance and title, and although they benefit from the blockchain technology, which creates clear, timestamped audit trails of ownership, the risk of fraud persists, particularly in light of the anonymity of blockchain.

Fraudsters could mint an NFT relating to a work that is not their own and without the creator's permission. For example, an online auction of an NFT purportedly by Banksy (a different Banksy NFT to the one referred to above) was subsequently found to be fraudulent and not in any way affiliated with the artist, despite there being a link to the NFT auction on the artist's website (which was added by the fraudster). Likewise, with respect to copyright, minters of NFTs could falsely claim to own copyright in respect of the underlying asset.

These risks can be mitigated by purchasing NFTs from reputable creators, or by undertaking proper due diligence as to its provenance if buying on a secondary market. For instance, DLA Piper's TOKO platform combines innovative blockchain technology with the compliance and regulatory rigor of a global law firm to tackle and eliminate such risks of fraud and enhance auditing capabilities.

Uncertain regulatory framework

Where NFTs are traded across global platforms, issuers and buyers must be aware of the legal and regulatory treatments across different jurisdictions. However, since NFTs are a relatively new asset class, much of the legal and regulatory framework surrounding NFTs is still under development both in the UK and across the globe.

Based on current guidance published by the UK FCA in 2019, it is likely that many NFTs would be considered as "unregulated tokens" since they do not meet the definition of either electronic money or security tokens. However, it is possible that certain types of NFT could constitute a type of regulated financial instrument such that it falls within the UK's regulatory perimeter. Careful analysis of the classification and regulation of each NFT transaction is therefore required.

The considerable sums that are often spent on NFTs, coupled with the fact that sellers and buyers of NFTs often remain anonymous, can make NFTs attractive to those interested in laundering money. Operators of NFT platforms need to be alive to such risks, and ensure they comply with their applicable regulatory duties.

The UK has transposed the EU's Fifth Anti-Money Laundering Directive 2018/843 into the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs). This new regime came into force in January 2020. The MLRs now require cryptoasset exchange providers and custodian wallet providers to register with the Financial Conduct Authority before undertaking any cryptoasset business. Given the broad definition of "cryptoassets" under the MLRs, it is possible that businesses dealing with certain NFTs will fall within its scope.

As the popularity of NFTs continues to rise, so too does the likelihood of further regulation of the sale, distribution and marketing of NFTs.

Conclusion

NFTs offer exciting opportunities for digital creators, sellers and buyers alike. Nevertheless, as the market continues to evolve, it is crucial that buyers are aware of and understand the risks inherent in these products.

To minimise these risks, buyers should carefully consider what they are purchasing, ensure that any embedded smart contract accurately reflects the rights they anticipate receiving, and only purchase and deal in NFTs on reputable marketplaces.

Proposed reform of UK wholesale market rules – What does this mean for commodity derivative markets?

On 1 July 2021, HM Treasury (Treasury) launched a Consultation on proposals to reform the UK's wholesale markets regulatory framework (Consultation).

The UK government wishes to update this framework in the post-Brexit environment to enhance the UK's openness and global competitiveness whilst still maintaining high regulatory standards.

The Treasury is reviewing the feedback to the Consultation, which closed on 24 September 2021. The Consultation has raised a number of proposed significant changes to the commodity derivatives market in the UK including on position limits, reducing the scope of financial instruments caught in-scope of regulation and making exclusions from regulation easier to comply with.

Changes to the MiFID II Foundation

The UK wholesale markets regulatory framework is currently based on the Markets in Financial Instruments Directive 2014/65/EU, associated regulation and delegated EU legislation (MiFID II). The UK has made a number of minor amendments of its own MiFID II framework to reflect its departure from the EU. No significant changes have been made to date which would result in any significant divergence from EU rules.

Through the Consultation, the Treasury is seeking feedback on how the UK's approach to regulating secondary markets should be updated in the post-Brexit environment. While the Ministerial Forward to the Consultation states that this Treasury Review is "not about lowering standards for wholesale capital markets," the Consultation does propose some significant departures from MiFID II rules – for example, removing the double volume cap.

The Minister's view is that these regulations do not protect market integrity or encourage competition. Removing certain regulatory requirements will "ensure effective targeting of risk and resource by firms and regulator and bring greater competition."

We do not address all the Treasury proposals in the Consultation in this article but instead focus only on the proposals in the Consultation relating to the commodity derivative markets.

A return to the prior approach on position limits

The current position under the MiFID II framework is that the Financial Conduct Authority (FCA) is required to establish and apply position limits on the size of a net position in commodity derivatives traded on trading venues and economically equivalent Over-The-Counter (OTC) contracts.

These limits apply to the size of a position that an entity can hold (including any other positions held on behalf of that entity, such as by group entities). Trading venues apply position management controls, including monitoring of open interest and obtaining information on, inter alia, positions entered into and their owners.

The EU has recently amended and simplified the position limit rules by the Directive on information requirements, product governance and position limits (2021/338/EU, Quick Fix Directive), which is to be transposed into national laws and applied from 28 February 2022. The UK has implemented the Quick Fix Directive via the Markets in Financial Instruments (Capital Markets) (Amendment) Regulations 2021 which has applied since July 2021.

In the Consultation, the Treasury is proposing more far-reaching changes to the rules on position limits. The Treasury proposes to revoke the requirement for position limits to be applied to all exchange traded contracts and transfer the setting of position controls from the FCA to trading venues. This was the case before the MiFID II regime became applicable.

Reducing the scope of MiFID II financial instruments

The Consultation also proposes to reduce the scope of the MiFID II regime by removing from the scope of MiFID II "financial instruments":

- "commodity derivatives" that are not based on physical commodities;
- other types of financial instruments which refer to commodities as a pricing element but are securities in their legal form; and OTC contracts that are economically equivalent to exchange traded commodity derivates.
- The scope of MiFID II would therefore be limited to agricultural contracts and physically settled contracts. By way of example, derivatives based on climate variables would be removed from scope of UK MIFID II. The rationale behind the proposed reduction is to remove the legal risk and compliance costs arising from uncertainty about which contracts are in the scope and which are not.
- The EU MiFID II regime is likewise being reduced through the Quick Fix Directive, however not as significantly: the EU MiFID II financial instruments will still include agricultural commodity derivatives and critical or significant commodity derivatives traded on trading venues and their economically equivalent OTC contracts.

Ancillary activities exclusion update

The Consultation proposes amendments to the ancillary activities exclusion by reverting to the qualitative ancillary activities test, which was in place before the MiFID II regime.

The "new" test:

- follows a principles-based approach, which considers the nature of an entity's business more holistically according to criteria set by the FCA;
- is forward-looking and provides for a more proactive assessment of an entity's expected activities; and
- removes the need to annually confirm to the FCA that the threshold has not been reached and that the exclusion is being relied upon.

The ancillary activities test under the current MiFID II regime is quantitative – and often requires entities to perform complex calculations and process substantial volumes of historical trading data. Since it was introduced in 2018, no firms have exceeded the threshold, which suggests that the test is not fully effective.

According to HM Treasury, the proposed ancillary activities test is more streamlined, proportionate and cost effective. The EU Quick Fix Directive also amended the ancillary activities test; however, it is a more limited change than that posed by HM Treasury. EU national regulators will be able to combine a quantitative and qualitative assessment, based on guidance to be issued by the European Commission.

Out-of-scope: Oil market participants and energy market participants

Finally, The Consultation proposes to delete the oil market participants (OMP) and energy market participants (EMP) regimes as set out in the FCA Handbook.

Originally the OMP and EMP regimes were designed to be temporary.

The Treasury now proposes that Entities subject to the OMP or EMP would become subject to the MiFID II requirements for commodity derivates – unless they fall out of the scope of the new ancillary activities test.

Next steps for participants in the commodity derivatives markets

The Consultation closed on 24 September 2021. The Treasury has not yet specified timeframes for when it will respond with next steps.

The Consultation is a significant step in the next phase of capital markets regulation in the UK.

While the UK had hoped for a range of equivalency decisions from the European Commission following the conclusion of the Trade and Cooperation Agreement at the end of 2020, these decisions were not forthcoming. Accordingly, the Consultation demonstrates a new willingness by the UK to diverge from EU regulatory standards in order to tailor the UK regulatory regime more closely to the unique circumstances and markets of the UK.

For participants in the commodity derivatives markets, the proposals – if enacted – will result in a significant lessening of regulatory responsibility and associated compliance burden and cost.

For participants with operations across Europe, however, an added complexity will be complying with divergent regulatory regimes in the UK and EU going forward.

UK Regulators set out expectations for Diversity and Inclusion in the Financial sector

On 7 July 2021, three UK regulators (the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA) and the Bank of England) published Discussion Paper 21/2: Diversity and inclusion in the financial sector – working together to drive change (DP 21/2).

A collective commitment to faster change

In DP 21/2, the regulators acknowledge that the financial sector has taken steps forward on diversity and inclusion. Despite this, the regulators note that more needs to be done to create truly diverse and inclusive sector.

Large gender and ethnicity pay gaps still exist in the financial sector. There are some parts of the industry that lack diversity at senior levels, and some of the products offered to customers still do not meet the needs of disadvantaged groups. In publishing DP 21/2, the regulators are aiming to accelerate the pace of meaningful change in the sector.

There is clear momentum for change. Environmental, Social and Governance (ESG) issues are rising to the top of the agenda for corporates, investors and wider society. This is helpfully keeping diversity and inclusion at the forefront of the minds of boards, executives and staff.

Against this background, the regulators state in DP 21/2 that they need to make their expectations of firms clearer and root them in their statutory objectives, supported by the Public Sector Equality Duty introduced by the 2010 Equality Act.

The regulators acknowledge that many existing initiatives on diversity and inclusion have been driven by sector-specific developments. This has resulted in a fragmented requirements for different types of financial firms.

The regulators also acknowledge that they, as employers, have more work to do in encouraging diversity and inclusion.

Regulated firms in the financial sector

DP 21/2 refers to "firms" broadly in the financial sector. This includes firms regulated jointly by the PRA and FCA under the Financial Services and Markets Act 2000 (banks, building societies, designated investment firms, credit unions and insurance firms) or those solely regulated by the FCA such as payment services and electronic money firms, credit rating agencies and recognised investment exchanges.

In addition, "firms" included in DP 21/2 also extends to Financial Market Infrastructures (FMIs) which are supervised by the Bank of England.

Broad definitions of diversity and inclusion

In DP 21/2, the regulators define diversity broadly as the bringing together of a "range of different styles of thinking among members of a group. Factors that could lead to diverse thinking could include, but not be limited, to different perspectives, abilities, knowledge, attitudes, information styles, and demographic characteristics, or any combination of these."

Diversity of thought can be influenced by many factors including demographic characteristics which may affect viewpoints and life outcomes. These can be visible and measured, such as gender, age and ethnicity, or non visible, such as disability, sexual orientation and education. They do not only include the nine protected characteristics defined in the Equality Act 2010 (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation), but can also include other factors, such as socio economic diversity, gender (including where it does not coincide with sex), and cultural background.

The regulators note that diversity alone is not enough. Much of the focus in this space has tended to be on diversity without equal concern being paid to the importance of inclusivity.

In DP 21/2, the regulators define "inclusion" broadly as being "the practice or policy of providing equal access to opportunities and resources for people who might otherwise be excluded or marginalised – for example, due to demographic characteristics." An inclusive culture allows individuals to participate fully and where views and contributions are valued and fully considered regardless of differences due to demographic characteristics or background.

The concepts are interconnected. Greater diversity should support having a range of views across an organisation, while inclusion should create the necessary environment for individuals to be able to express these views, speak up and raise concerns.

The Benefits of Change

In DP 21/2, the regulators cite some of the growing evidence that diversity of thought, when part of an inclusive culture, supports better decision making by firms.

For example, the regulators cite the academic work of Arnaboldi et al (2020)[1], who examined fines received by EU banks from US regulators. They found that greater female representation on the board significantly reduced the frequency of misconduct fines with female directors more influential once they reached a "critical mass."

Alongside DP 21/2, the regulators published a literature review with the developing evidence of the impact of diversity and inclusion in the workplace.

Diversity and inclusion can reduce groupthink, encourage debate and innovation and thereby improve outcomes for consumers and across markets, supporting financial stability. According to the regulators, diversity and inclusion make business sense – from both a financial and a consumer perspective. It also assists in meeting their statutory objectives in that diversity and inclusion contribute towards well-functioning markets, the integrity of the financial system, consumer protection and promote effective competition.

Measuring progress

In DP 21/2, the regulators outline the importance of data collection, reporting and monitoring advances in diversity and inclusion. Firstly, high-quality data supports evidence-based policymaking by helping regulators identify ways in which they can make the most effective policy interventions, support supervisory interventions and the shift to data-driven regulation. Secondly, they enable regulators to monitor firms' progress towards their stated objectives and targets.

Currently, data commonly collected by firms are around gender (broken down by division, function and seniority). More advanced firms are also collecting data on ethnic minorities and how these groups move throughout the employee lifecycle including recruitment, promotion and attrition.

The Regulators propose in DP 21/2 to launch a one-off, voluntary pilot data survey in Autumn 2021. This survey will allow the regulators to understand more deeply categories of data firms collect and what strategies firms are undertaking. The data collected will inform future regulatory policy development. The survey will involve a representative sample of solo-regulated firms, all firms jointly regulated by the PRA and FCA and selected FMIs. Firms to be included in the sample will be contacted by the regulators in due course.

Driving change: Culture and policy

Chapter 5 of DP 21/2 sets out some potential policy options that the regulators consider could be effective in driving progress on diversity and inclusion in firms.

The regulators state that any such policy drivers will be proportionate given the differences between firm size and complexity. While the regulators note that they will not be adopting a one-size-fits-all approach, the regulators also stressed that smaller firms will not necessarily be out of scope.

One option the regulators contemplate in DP 21/2 is adapting the Senor Managers and Certification Regime (SM&CR) categorisation of firms as enhanced, core and limited scope when it comes to diversity and inclusion requirements. The regulators are also seeking views on whether overseas firms that operate in the UK through branches should also be in-scope of these requirements.

Tone from the top

The regulators note the importance of the board and senior managers of firms in establishing inclusive cultures and monitoring/challenging progress on diversity.

1 Arnaboldi, F., Casu, B., Gallo, A., Kalotychou, E. and Sarkisyan A. (2020). Gender Diversity and Bank Misconduct. CASS. Centre for Banking Research Working Paper Series, WP 01/20.

The regulators expect that diversity and inclusivity is a key consideration in recruitment (and succession planning) of board members whilst acknowledging this needs to be considered proportionally for firms with smaller sized boards.

The regulators acknowledged that the SM&CR is an important policy tool for making senior leaders at in-scope firms directly accountable for diversity and inclusions in firms. Two of the PRA's Prescribed Responsibilities dealing with culture must be allocated to approved Senior Managers in dual-regulated firms. In DP 21/2, the regulators noted that these Prescribed Responsibilities could be amended to make the link between culture and diversity and inclusion even clearer.

For firms that do not have to allocate these Prescribed Responsibilities, the regulators envisage that the need to drive diversity and inclusion could be mandated as part of Senior Managers' Statements of Responsibilities.

The regulators in DP 21/2 also contemplate linking progress on diversity and inclusion to remuneration (both fixed and variable) as a key tool for driving accountability in firms and incentivising progress. The regulators could develop guidance on how metrics linked to diversity and inclusion could be used as part of the non-financial criteria when setting variable remuneration awards. Similarly, poor performance in this area could be grounds for adjustment.

Firmwide policies and practices

In DP 21/2, the regulators note the importance of firms having in place a diversity and inclusion policy. Clearly documented policies help set out expectations for all staff. The regulators do not propose to be prescriptive about the content of these policies. At a minimum, however, these policies should promote diversity of the board.

Available data indicate less diversity towards the top of firms. This is where key decisions that have significant impacts on safety and soundness, consumer protection and markets regularly take place. Accordingly, the regulators propose that future initiatives should focus on the diversity of senior management and the progress that firms are making. A consistent definition of "senior management" across all regulated firms for the purposes of monitoring diversity would support benchmarking between peers. This definition may also be used by the regulators in any future diversity reporting and disclosure policy.

In DP 21/2, the regulators also are seeking views on the merits of targets to improve board and senior management diversity as well as customer-facing roles. Where targets are used, the regulators expect them to be stretching enough, with a defined timeframe, to contribute towards meaningful change.

The regulators also note that employees at firms should understand that the reasons why diversity and inclusion is important to their firm. The regulators are aware that evidence for some diversity training is mixed.

The regulators also intend to consult on requirements to publicly disclose a selection of diversity data on the senior management and employee population as a whole, as well as relevant policies.

Regulatory measures

Before a Senior Manager subject to the SM&CR is approved to carry out a controlled function, the firm and its regulators must be satisfied that the person is "fit and proper" to carry out their role. This includes an assessment of the individual's honesty, integrity and reputation. The Bank of England scrutinises candidates for senior management roles at FMIs in a similar way.

In DP 21/2, the regulators note that they are exploring whether adverse findings when it comes to fitness and properness should affect its assessments in the future. There have been instances where the FCA has found an individual not to be fit and proper on the basis of "non-financial misconduct." The regulators could develop guidance on what such misconduct constitutes. It may include evidence of sexual harassment, bullying and discrimination on the basis of someone's protected (or otherwise) characteristics. Regulators may also collect diversity data about the individual as part of the information provided in Senior Management Function applications, subject to applicable data protection rules.

More broadly, the regulators note that evidence of a firm engaging in discriminatory activities could itself result in that the firm not meeting its threshold conditions to carrying out regulated business in the UK. Going forward, the regulators intend to embed diversity and inclusion into their existing supervisory practices.

FCA to strengthen financial promotions rules for high-risk investments

The FCA is considering what changes it should make to its financial promotion rules to help retail investors make more effective decisions (see DP21/1).

The FCA's proposals are unsurprising given the harm seen recently in the retail investment market, for example, the losses suffered by investors following the collapse of London Capital and Finance, mass-marketing of high-risk products which are unsuitable, and abuse of the financial promotions exemptions by unauthorised firms.

Although the FCA recognises that higher risk investments can have a place in a well functioning consumer investment market for those consumers who understand the risks and who can absorb potential losses, they have put forward proposals which could have a significant impact on the business models for certain firms. The FCA proposals have the potential to make the customer investment journey (particularly where it is online) burdensome and potentially unattractive to investors.

Firms that approve financial promotions for unauthorised persons should also expect enhanced regulatory obligations.

Next steps

The consultation closed on 1 July 2021. The FCA intends to test its proposals using behavioural research to obtain better insight on the effectiveness of the measures. The FCA plans to consult on rule changes later this year.

The FCA will also publish a full response to the call for input, together with the next steps in its wider consumer investment strategy and a second summary of its work to tackle harm in the consumer investment market.

The proposals relating to the FCA "gateway" for authorised firms that approve financial promotions for communication by unauthorised persons (section 21 approvers) will require a change in legislation. We understand that the government intends to bring forward the relevant legislation when parliamentary time allows. The FCA has also said that it intends to consult on its proposals for implementing the gateway in due course.

What is a financial promotion?

A financial promotion is an invitation or inducement to engage in investment activity that is communicated by way of business.

- There are three ways to communicate a financial promotion:Authorised firms can communicate their own financial promotions but must comply with the FCA rules – for example, the overarching fair clear and not misleading requirement, and the restrictions set out in COBS 4, in particular COBS 4.7 (direct offer promotions of non-readily realisable securities (NRRS) and P2P agreements), COBS 4.12 (promotions of non-mainstream pooled investments (NMPIs), and COBS 4.14 (promotions of speculative illiquid securities (SISs). Broadly speaking, more restrictions apply to high-risk products.
- Authorised firms can approve financial promotions for communication by unauthorised persons. The FCA rules noted above apply to the authorised firm. The FCA reminded firms that there is (currently) an expectation that the approver is heavily involved beyond the financial promotion for an NMPI or SIS as it has responsibility for ensuring compliance with COBS 4, including ensuring, where applicable, that the product is appropriate for each investor.
- Unauthorised persons can communicate financial promotions without any approval if they comply with the conditions of an exemption in the Financial Promotions Order, eg to a High Net worth Investor (HNWI) or sophisticated investor. The FCA proposals do not cover financial promotions by unauthorised persons under the financial promotion exemptions – this is outside the remit of the FCA and so government intervention is required. The government in its consultation on the "Regulatory Framework for Approval of Financial Promotions"; noted that it will continue to keep the legislative framework underpinning the regulation of financial promotions under review.

The FCA proposals

CHANGES TO THE WAY INVESTMENTS ARE CURRENTLY CLASSIFIED

The FCA is exploring the following:

- Including equity shares as a type of security that can be a SIS alongside debentures and preference shares (so they cannot be mass-marketed).

  The FCA has in the past seen some structures which involve ordinary shares issued to raise capital for speculative purposes, with a focus on attractive returns and the implication that they are secure or asset-backed. The FCA is also concerned that ordinary shares could offer an easy arbitrage for issuers seeking to raise funds for highly risky and opaque activities that are more akin to unregulated collective investment schemes but which are structured to remain outside the definition of an NMPI. The FCA plans to target equity shares issued for on lending, buying or acquiring investments or buying or funding the development of property, but has asked for views on whether there are any other features of investments which may make them inappropriate for retail investors.

- Whether existing requirements for P2P platforms adequately protect retail investors from the risks of P2P agreements which share features with SISs (or should mass marketing of these products also be banned).

  The FCA is also proposing to make changes to the definition of readily realisable securities (RRS) – currently these include government-issued securities and UK/EEA listed securities. The FCA said that it no longer considers it appropriate to treat EEA exchanges differently to exchanges in other third countries (eg the US) and so is proposing to remove "or EEA State" from the definition of RRS for the purposes of its financial promotion rules. The FCA also wants to remove any fixed income securities traded on an exchange regulated MTF from the definition.

Strengthening the process for categorising retail investors

The FCA noted that there are several changes it could make to strengthen the process for categorising retail investors (as HNWIs etc.), for example, it could require firms to:

- take reasonable steps to independently verify that a retail investor meets the relevant requirements to be characterised as a HNWI or sophisticated investor– previous arguments that checking payslips or bank statements are too onerous or intrusive are likely to be rejected by the FCA, who countered that the development of Open Banking and Open Finance technologies reduce the burden of verification;
- have grounds to reasonably believe that an investor meets the relevant requirements (and to document those grounds);
- have regard to any information that they hold about the relevant individual from other interactions, or collected as part of the appropriateness or preliminary suitability assessment, when considering whether to question a declaration; and/or
- to question or verify declarations where there are certain red flags – for example, where an investor attempts to invest an amount over a certain threshold.

Possible ways suggested by the FCA to help consumers better categorise themselves include the following:

- Clearer and more prominent risk warnings at the point when the investor makes the declaration.
- Designing the clearer risk warning to directly address social and emotional drivers of investment choice that may induce people to make an incorrect declaration (to address harms caused where investors are coached into saying the right things to satisfy the relevant criteria).
- Making other changes to make customers make an active choice, eg banning the use of pre-ticked boxes; changing the format of the declaration; introducing positive frictions into the declaration process to encourage reflection and more mindful interaction.

The FCA is also considering how other positive frictions could be added to the consumer journey in response to a financial promotion and how it could help further segment high-risk investments from the mass market – to stop a consumer from simply "clicking through" and accessing high-risk investments.

The ideas considered by the FCA include deposit collection and introducing cooling-off periods – for example, by requiring SMS confirmations before investments are made. More burdensome ideas include requiring consumers to watch education videos or pass an online test before investing.

Improving risk warnings

The FCA considers that although risk warnings alone cannot address the challenges identified, there is a role for a clear, prominent and concise risk warning and that more can be done to help consumers engage with them. Behavioural experiments run by the FCA alongside Warwick Business School on the relative effect of the standard "Your capital is at risk warning" against the standardised risk warning for SIS products showed that the SIS risk warning improved investors' comprehension of the risks of investing in speculative mini bonds.

The FCA has asked for views on whether the SIS risk warnings should be applied more broadly. The FCA is also keen to explore whether visual based risk warnings could help influence consumer behaviour.

Enhancing requirements on "section 21 approvers"

In addition to the FCA "gateway" for approval of financial promotions (see related developments below), the FCA is considering whether it should include more prescriptive requirements for "section 21 approvers" to actively monitor a financial promotion after approval, so they are in a better position to assess whether it needs to withdraw its approval at any time.

Specific ongoing monitoring requirements suggested include requiring firms to check the following:

- Whether any amendments made to a promotion would require it to be re-approved.
- Whether there has been any changes that may affect whether the promotion continues to be fair, clear and not misleading, eg changes in matters covered by the due diligence on the issuer/ investment, reconsideration of the ongoing viability of the proposition described in the promotion, or whether the advertised rates of return continue to be reasonably achievable.
- Whether the funds raised are being used for the purposes described in the financial promotion.
- Whether relevant requirements, including the new requirements that the FCA introduce, are being followed.

As noted above, the FCA expects a "section 21 approver" to be heavily involved in the investment process for an NMPI or SIS. However, the FCA considers that more could be done in relation to approval of direct offer financial promotions of NRRS and P2P agreements as there is currently no explicit expectation that a section 21 approver is actively involved on an investor by investor basis in the same way as for NMPIs or SISs. The FCA is considering how involved a section 21 approver should be in an automated online appropriateness process operated by the unauthorised person on an ongoing basis, eg a requirement on the section 21 approver to check that the process complies with FCA rules on an ongoing basis.

Ireland

Central Bank of Ireland – Enforcement action against Irish management company concerning governance and intentional investment restriction breaches

On 27 September 2021, the Central Bank of Ireland (CBI), in accordance with its administrative sanctions procedure (ASP), reprimanded and fined an Irish domiciled UCITS management company (Firm) EUR385,000 in respect of four admitted breaches of investment funds regulations, including intentional investment restriction breaches and breaches related to oversight of delegates and governance.

In relation to the intentional investment restrictions breaches, the CBI identified that a discretionary investment manager appointed by the Firm, while completing a UCITS merger of two funds managed by the Firm, deliberately breached certain investment concentration restrictions set down in UCITS fund legislation and in the prospectus of the merging UCITS.

During the course of the ASP, the CBI also identified several instances of ineffective reporting and communication procedures with the Firm's delegates, including:

- a failure to ensure timely provision of delegates' reports to the board of the Firm and to designated persons involved in the senior management of the Firm and in certain instances, documenting such reports as having been received, where this was not accurate;
- a failure in exceptions based reporting and escalation reporting, resulting in late escalation of intentional breaches to the board of the Firm;
- ineffective supervision and monitoring of delegates of the Firm;
- a failure to engage in ongoing supervision and monitoring of significant projects (such as the UCITS merger) where there were clearly identified risks of which the board of the Firm was aware; and
- a failure to keep a designated director for monitoring compliance in place, during a period where the appointed individual was on extended sabbatical leave.

Compliance by fund management companies and funds with applicable fund legislation, CBI guidance as well as their fund documents and any documented policies, procedures and regulatory business plans/programmes of activities, will continue to be an area of focus for the CBI.

The CBI expects each fund management company, notwithstanding the delegation of functions, to exercise appropriate governance, oversight and monitoring programmes (including proactively challenging the activities and scrutinising the actions taken by their delegates) on an ongoing basis but also when specific risks arise.

Boards of directors and senior management within fund management companies and funds should review their existing operations to ensure that they are paying sufficient attention to delegation arrangements.

This sanction is a further indication that the CBI is actively conducting enforcement investigations and will hold funds, fund management companies and other fund service providers, and individuals who work in these firms, responsible for compliance with regulatory and governance obligations and for ensuring appropriate oversight of delegation arrangements.

Cross-border distribution of investment funds – Irish developments

The EU's new regulatory framework facilitating the cross-border distribution of collective investment undertakings comprises:

- a Regulation ((EU) 2019/1156) on facilitating cross-border distribution of collective investment undertakings and amending the EuVECA (Regulation (EU) No 345/2013) and EuSEF (Regulation (EU) No 346/2013) Regulations (the CBD Regulation); and
- a Directive ((EU) 2019/1160) which amends the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the Alternative Investment Fund Managers Directive (AIFMD) with regard to cross-border distribution (the CBD Directive).

The key objectives of the European and Irish legislation is to facilitate EU cross-border distribution of undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIFs) and to harmonise the regulatory framework governing the distribution of such investment funds.

Implementation into Irish Law

The CBD Regulation, which is directly effective, came into effect in August 2019 with the provisions relating to marketing largely commencing from 2 August 2021.

The EU (Undertakings for Collective Investment in Transferable Securities) (Amendment) Regulations 2021 and the EU (Alternative Investment Fund Managers) (Amendment) Regulations 2021 have now been signed into Irish law. The new legislation, which transposes into Irish law certain terms of the CBD Directive, enters into force from the 6 August 2021.

Particular attention should be given to the new pre-marketing regime applicable to AIFs, the applicable conditions for marketing discontinuation applicable to UCITS and AIFs, the requirement to provide local facilities for AIFs and UCITS marketed to retail investors, and also the content requirements for marketing communications including the potential requirement to submit copies of such communications for prior review by regulatory authorities.

Regulatory website guidance on marketing requirements and regulatory fees

On 29 July 2021, the Central Bank of Ireland (CBI) published website guidance (as required under Articles 1 and 2 of the Cross-Border Fund Distribution Level 2 Measures (Commission Implementing Regulation (EU) 2021/955)) in relation to the marketing requirements and regulatory fees and charges for UCITS and AIF products.

Information on the national laws, regulations and administrative provisions in Ireland governing marketing requirements (as referred to in Article 5(1) of the CBD Regulation) has been published by the CBI and is available here for UCITS and here for AIFs.

Information on the fees and charges levied by the CBI for carrying out its duties in relation to the cross-border activities of UCITS management companies, AIFMs, EuSEF managers and EuVECA managers referred to in Article 10(1) of the Cross-Border Fund Distribution Regulation has also been published by the CBI and is available here for UCITS and here for AIFs.

Germany

Germany introduces new investment fund category of development promotion funds

To strengthen Germany as a fund location, the German legislator has enacted the Fund Location Act (*Fondsstandortgesetz – FoStoG*) which, for the most part, came into force on 2 August 2021.

The innovations adopted are intended to increase the competitiveness of Germany as a location for investment funds and to further reduce bureaucratic hurdles. In addition to changes to other laws, the FoStoG introduces specific liberalisations of the German Investment Code (*Kapitalanlagegesetzbuch – KAGB*) and new fund categories.

In particular, the legislator has introduced the new fund vehicle of the so-called development promotion fund (*Entwicklungsförderungsfonds*). This is a special AIF, ie available to professional investors, which must predominantly invest in assets measurably leading to the achievement of the goals set by the UN for sustainable development.

The introduction therefore serves to implement a special impact fund that is aimed at promoting sustainability by investing in accordance with the Sustainable Development Goals as set out in the resolution of the General Assembly of the United Nations of 25 September 2015, in countries included in the list of developing countries and territories maintained by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD).

To achieve its purpose, a development promotion fund may be established either as an open-ended or closed-ended domestic special fund. The fund may grant loans as well as assume sureties, guarantees and other warranties, provided that the investment management company has implemented appropriate procedural and compliance measures.

For the effective implementation of the purpose of the fund it is the task of the fund management company to establish a procedure for measuring the existing positive impact potential at the launch of the fund and to ensure ongoing transparency and clarity of the procedures.

The fund management company is obliged to become a signatory of the Operating Principles for Impact Management of the International Finance Corporation of the World Bank.

To ensure liquidity, the fund management company may also invest, on behalf of the development promotion fund, an amount equivalent to 30% of the fund's value in bank deposits, money market instruments, certain shares in other highly secure special funds and securities. Derivatives may be employed for hedging purposes.

To ensure ongoing compliance with the Operating Principles for Impact Management, in case two consecutive audits according to Principle 9 (independent verification) revealed a material incompliance, the fund must be terminated with six months' notice.

EU

EBA launches public consultation on draft regulatory technical standards (RTS) to identify shadow banking entities for the purposes of reporting large exposures

On 26 July 2021, the European Banking Authority (EBA) launched a public consultation on regulatory technical standards (RTS) to set out several criteria to identify shadow banking entities for the purposes of reporting large exposures.[1] The consultation ran until 26 October 2021.

The draft RTS provides three main legal provisions addressing the criteria for identifying both shadow banking and non-shadow banking entities, principles to define banking activities and services, and criteria for excluding entities established in third countries considered as shadow banking entities.

The approach in the EBA guidelines to identify shadow banking entities carves out certain entities from the scope of the definition. Such excluded entities are those subject to an appropriate and sufficiently robust prudential framework. In a nutshell, entities that carry out banking activities or services and have been authorised and are supervised in accordance with their regulatory framework or are exempted or excluded from the application of any legal acts, notably the CRR, the CRD, EMIR and Solvency II, will not be considered shadow banking entities. On the contrary, all other entities providing banking activities and services will be considered shadow banking entities – however, specific rules apply to certain collective investment undertakings.

Considering the characteristics of funds regulated under the Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive and the Alternative Investment Fund Managers Directive (AIFMD), special provisions are included in the draft RTS. In view of the severe liquidity issues that affected money market funds (MMFs) during the COVID-19 crisis and the ongoing discussions at EU and international level to strengthen their regulation, MMFs are identified as shadow banking entities.

Finally, the draft RTS consider the situation of entities established in third countries and provide for a treatment that distinguishes between banks and other entities. Banks would not be identified as shadow banking entities provided that they are authorised and supervised based on at least the Basel core principles for effective banking supervision; other entities would not be identified as shadow banking entities provided that they are subject to a regulatory regime recognised as equivalent to the one applied in the Union for such entities.[2]

Legal basis and background

The main basis for the development of the draft RTS has been the guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013. These guidelines were published in December 2015 to give effect to the mandate contained in Article 395(2) CRR.

According to Article 394(2) CRR, as amended by Regulation (EU) 2019/876, "institutions shall report the following information to their competent authorities in relation to [...] their 10 largest exposures to shadow banking entities which carry out banking activities outside the regulated framework on a consolidated basis, including large exposures exempted from the application of Article 395(1) [...]."

1 Consultation paper: Draft Regulatory Technical Standards on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013

2 In accordance with the equivalence provisions of the relevant Union legal act.

Article 394(4) CRR mandates the EBA "to develop draft regulatory technical standards to specify the criteria for the identification of shadow banking entities referred to in paragraph 2. In developing those draft regulatory technical standards, EBA shall take into account international developments and internationally agreed standards on shadow banking and shall consider whether (a) the relation with an individual entity or a group of entities may carry risks to the institution's solvency or liquidity position; (b) entities being subject to solvency or liquidity requirements similar to those imposed by the CRR and Directive 2013/36/EU should be entirely or partially excluded from the respective reporting obligations."

ECB and Eurosystem launch the digital euro project

On 14 July, the European Central Bank (ECB) announced that the Governing Council of the ECB has decided to launch the investigation phase of a digital euro project. The President of the Eurogroup expressed his full support for the project.

The digital euro would be the CBDC (Central Bank Digital Currency) of the Eurozone: the digital version of the fiat currency. In essence, the digital euro would be the digital equivalent of the physical euro in cash. A virtual currency parallel to banknotes, legal tender and guaranteed by the European Central Bank, used for payments in the 19 countries of the euro area and accessible to businesses and citizens to pay in a faster, safer and more innovative way. A digital euro could also support the general economic policies of the EU. It could satisfy the emerging payment needs of a modern economy by offering, alongside cash, a safe digital asset with advanced functionalities.

The investigation phase will last 24 months and aims to address key issues regarding design and distribution of the digital euro. This investigation is the follow-up phase of the publication of the ECB report on a digital euro and its positive results on how the digital euro could support the Eurosystem's objectives by providing citizens with access to a safe form of money in the fast-changing digital world. The investigation phase will benefit from the experimentation work done by the Eurosystem over the past nine months and will focus on the following priority objectives: a riskless, accessible, and efficient form of digital central bank money.

During the project's investigation phase, the Eurosystem will focus on a possible functional design that is based on users' needs. It will also assess the potential impact of a digital euro on the market, identifying the design options to ensure privacy and avoid risks for euro area citizens, intermediaries and the overall economy. It will define a business model for supervised intermediaries in the digital euro ecosystem. A market advisory group will take account of prospective users' and distributors' views on a digital euro during the investigation phase.

The project will also address the several issues related to the changes to the EU legislative framework which might be needed and will be decided by European co-legislators.

ECB to take over supervision of systemic investment firms

On 25 June 2021, the European Central Bank (ECB) communicated that it will take over supervision of systemic investment firms under the new EU legislation, which applies as of 26 June 2021.[1]

The Investment Firms Regulation and Investment Firms Directive[2] introduce a new framework for the prudential supervision of investment firms. The largest and most systemic investment firms (referred to as Class 1 investment firms) must apply for a licence from the ECB and hence become subject to European banking supervision, under which significant banks will be directly supervised by the ECB.

More specifically, the EU legislation defines systemic investment firms as those that trade financial instruments on their own account or place financial instruments on a firm commitment basis and have total consolidated assets above EUR30 billion. The first set of investment firms newly authorised as credit institutions within the ambit of the Capital Requirements Regulation[3] are expected to be added to the list of supervised banks in the second half of 2021, thus becoming subject to European banking supervision.

For the other new categories of investment firms (Class 2 and 3 investment firms), on 5 July 2021, the European Banking Authority (EBA) published final draft regulatory technical standards (RTS) and Implementing Technical Standards (ITS) on the cooperation and information exchange between competent authorities involved in prudential supervision of such investment firms. These draft standards, developed in consultation with the European Securities and Markets Authority (ESMA), are intended to provide for a solid framework for (i) cooperation in the supervision of investment

1 Art 2 (2) Regulation (EU) 2019/2033 (IFR) and Art 1 (3) Directive 2013/36/EU in accordance with the second subparagraph of Art. 1 (2) of Regulation (EU) 2019/2033.

2 European Commission developed a new prudential framework, consisting of the Directive (EU) 2019/2034 (IFD)

3 Cf. The new definition of „credit institution" according to Art. 4 (1) no 1 Regulation (EU) 575/2013 as amended.

firm groups through colleges of supervisors and (ii) for information exchange for investment firms operating in the EU through branches or the free provision of services.

The final draft RTS on colleges of supervisors for investment firm groups specify the conditions under which colleges of supervisors exercise their tasks. All the standards apply to Class 2 and 3 investment firms and have been prepared reflecting on the supervisory experience in exchange of information and functioning of colleges for credit institutions, adjusting them to the needs of investment firms' supervision and embedding the proportionality principle.

Legal basis

The final draft RTS on colleges of supervisors for investment firm groups have been developed in accordance with Article 48(8) of Directive (EU) 2019/2034.

The final draft RTS and ITS on information exchange have been developed in accordance with Articles 13(7) and Article 13(8) of Directive (EU) 2019/2034, mandating EBA to develop regulatory and implementing technical standards on the exchange of information between home and host competent authorities supervising investment firms operating through branches.

US

Regulators propose guidelines for partnerships between banks and fintechs or other third-party relationships

Three federal bank regulatory agencies have proposed guidance that would clarify how banks can partner with fintechs and other financial services providers. The proposed guidance would replace each agency's existing, separate guidance and create a uniform approach.

The Proposed Interagency Guidance on Third-Party Relationships: Risk Management was jointly announced on 13 July by the Fed, the FDIC and the OCC. According to a 25 June memo prepared by Fed staff, the proposed guidance is based on the OCC's existing third-party risk management guidance from 2013. "The proposed guidance recognizes differences in the nature, level of risk, and complexity of banking organizations and their third-party relationships," the memo states.

The new proposal provides a framework based on sound risk management and describes third-party relationships as business arrangements between a banking organization and another entity, by contract or otherwise. Banks would be required to develop plans outlining their strategies for partnering and working with third parties, identifying risk, negotiating contracts, conducting ongoing monitoring and due diligence, and developing contingency plans for terminating relationships.

Regulators push banks to transition away from LIBOR by year's end

At its 11 June meeting, the Financial Stability Oversight Council urged banks to stop using the London Interbank Offered Rate (LIBOR) on new transactions by the end of 2021 – and warned that many firms are not moving in a timely manner to transition to the new benchmark, the Secured Overnight Financing Rate. According to a Treasury Department readout, the FSOC "also received an update from the Federal Reserve Board on the importance of accelerating the financial sector's transition from LIBOR and using reference rates for derivatives and capital markets products that have sufficient underlying volumes compared to contracts referencing the rate." Fed Vice Chair for Supervision Randal Quarles emphasized there is "no path forward" for LIBOR, which is being phased out after banks were fined for manipulating it, and that firms have no reason to delay moving derivatives and other market contracts to the Fed's preferred replacement, the SOFR. Quarles also warned banks that the use of USD LIBOR quotes available after December 2021 is appropriate only for legacy contracts, and using them for new products would create safety and soundness risks.

- The message was echoed by other senior officials, including Treasury Secretary Janet Yellen, Fed Chair Jerome Powell and Securities and Exchange Commissioner Gary Gensler.
    - Yellen said SOFR would "provide a robust rate suitable for use in most products and with underlying transaction volumes that are unmatched by other LIBOR alternatives." Yellen also questioned the use of alternative rates where the volume of derivatives contracts could outnumber the transaction volume underlying the reference rate.
    - Gensler expressed concern that a number of commercial banks have shown interest in the use of the Bloomberg Short-Term Bank Yield Index (BSBY) as a potential replacement for LIBOR, warning that BSBY could be vulnerable to the same type of manipulative conduct LIBOR fell victim to.
- The FSOC was created under Dodd-Frank to identify risks to US financial stability, promote market discipline and respond to emerging risks. The council is chaired by the Treasury Secretary and includes the major federal financial regulatory agencies, such as the Fed, FDIC, OCC and SEC.

Ransomware preparedness: NYDFS announces additional expectations of regulated entities' cybersecurity programs

The New York State Department of Financial Services announced new guidance addressing ransomware attacks and highlighting cybersecurity measures to significantly reduce the risk of an attack. The guidance comes amid increasing ransomware attacks and builds on NYDFS's April guidance on cybersecurity and supply chain risks.

On 30 June 2021, NYDFS posted an industry letter on its website to provide "Ransomware Guidance." The letter is not so much guidance as a ratcheting up of NYDFS's expectations of regulatees in addressing their own vulnerabilities to ransomware. The letter, for the most part, discusses the scope of the challenges and provides a list of nine "security controls" that NYDFS expects its regulatees to adopt. As discussed below, there is considerable, although not total, overlap with the White House memorandum recommendations.

In the letter, NYDFS cites outside sources for its assertion that ransomware attacks increased by 300 percent in 2020 and loss ratios on cyber insurance increased from 42% between 2015 and 2019 to 73% in 2020.

NYDFS reported in the letter that, as a result of the mandatory cyber event reporting requirements included in its Cyber Regulation, it has investigated 74 ransomware attacks, developed a playbook of ransomware methods and identified "security controls" that "can address each of the weaknesses commonly exploited by ransomware criminals." According to NYDFS, the controls "will substantially reduce" ransomware risk and DFS expects that all regulatees "should seek to implement the controls … to the extent possible."

Finally, if one were tempted to read this guidance letter as simply a list of suggestions, NYDFS reports that it is so concerned about ransomware and regulatees' responses that it is considering revising the existing Cyber Regulation to make some or all of the nine security controls mandatory.

The nine security controls

The nine security controls are a "defence in depth" approach, meaning that simply adopting one control is inadequate. NYDFS will expect regulatees to adopt all of the following controls "whenever possible" (separate guidance is provided for smaller businesses):

1. **Email filtering and anti-phishing training:** Regulatees' email systems should screen suspicious emails and require staff training on phishing.(This is not in the White House recommendations.)

2. **Vulnerability/patch management:** Regulatees "should have a documented program to identify, assess, track, and remediate vulnerabilities on all enterprise assets within their infrastructure. It states that "[w] henever possible, regulated companies should enable automatic updates."

3. **Multi-factor authentication (MFA):** Expanding on the NYDFS Regulation requirement for MFA for accessing a system remotely, NYDFS lists applying MFA for "privileged" accounts to prevent criminals from escalating through an organisation's systems.

4. **Disable RDP access:** Remote desktop protocol access should be disabled.(This is not in the White House recommendations.)

5. **Password management:** Regulatees should require passwords with a minimum of 16 characters and large organizations should "strongly consider a password vaulting PAM (privileged access management) solution"; and regulatees should disable password caching. (This is not in the White House recommendations.)

6. **Privileged access management:** Regulatees should ensure that each account user has the minimum level of system access necessary to their job.

7. **Monitoring and response:** "Regulatees should implement an Endpoint Detection and Response (EDR) solution" and larger companies should implement "lateral movement detection and a Security Information and Event Management (SIEM) solution…."

8. **Tested and segregated backups:** Companies should prepare for an attack by maintaining comprehensive backups for recovery purposes.

9. **Incident response plan:** Companies should have a plan in place to address ransomware attacks which is tested and includes senior leadership.

Statements in and the overall tone of the letter suggest that regulatees should expect that current examinations will focus on the implementation of these controls and whether regulatees have reported prior attacks within the timeframe set out in the Cyber Regulation.

Finally, it bears note that the NYDFS guidelines do not address two recommendations in the White House memorandum – segmenting corporate network and production/operational systems to reduce the threat of an operational shut down, and pen-testing. The latter is part of the NYDFS Cyber Regulations. The former bears consideration in light of the increase in operational ransomware attacks.

International

G7 public policy principles for retail central bank digital currencies

The development of cryptocurrencies as an alternative to traditional "fiat" currencies together with the continued move away from the use of cash (accelerated during the COVID-19 pandemic) has encouraged nation states to consider the development of their own central bank digital currencies (CBDCs).

The EU and the UK have been undertaking a considerable amount of thinking and consultation on how to develop robust CBDCs. According to the European Central Bank, a digital Euro CBDC is unlikely to be issued before 2026. The US has been similarly cautious on developing a USD CBDC. Conversely, China has been leading the race with its "digital yuan," that started public testing in April 2021. It is against this backdrop that consideration has been given to developing a series of principles which can form the foundation for developing CBDCs.

On 13 October 2021, the Group of Seven Nations (G7) published 13 public policy principles for retail CBDCs.

The joint statement by G7 Finance Ministers and Central Bank Governors highlighted that these principles were grounded in transparency, the rule of law and sound economic governance. The joint statement acknowledged that while digital money and payments could provide significant benefits, they also had the capacity to raise considerable public policy and regulatory issues.

The aim of these principles is to ensure international cooperation and coordination on these issues to capitalise on these potential benefits while minimising risk for the users and the wider financial system.

Principle 1: Any CBDC should be designed such that it supports the fulfilment of public policy objectives, does not impede the central bank's ability to fulfil its mandate and "does no harm" to monetary and financial stability

CBDCs have the potential to assist central banks in harnessing new technologies to enhance financial stability and continue serving the public. However, central banks would need to manage the impact of any additional innovation opportunities CBDCs may provide to banks and financial intermediaries during any transition phase for CBDCs. This would need to be addressed through appropriate design such as built-in safeguards which would moderate risks from rapid adoption with policy objectives and benefits around meaningful use of CBDCs.

The aim of these principles is to ensure international cooperation and coordination on these issues to capitalise on these potential benefits while minimising risk for the users and the wider financial system.

Principle 2: G7 values for the International Monetary and Financial System should guide the design and operation of any CBDC, namely observance of the rule of law, sound economic governance and appropriate transparency.

The G7 recognises that entities operating within the CBDC system could come into contact with personal data and it would be crucial to set up appropriate transparency and accountability frameworks for public and private players. Such national frameworks are vital to ensuring the financial system's confidence in CBDCs and to ensure its resilience and security.

Principle 3: Rigorous standards of privacy, accountability for the protection of users' data, and transparency on how information will be secured and used is essential for any CBDC to command trust and confidence. The rule of law in each jurisdiction establishes and underpins such considerations.

Privacy of CBDC users must be protected and the processing of their data should be subject to the privacy and data protection laws of each jurisdiction which may vary but would generally be governed by the principles of legality, purpose limitation, data minimisation, transparency and accountability, and user consent. The use of personal data should be highly transparent and any access beyond the minimum required should necessitate entities to set out the additional data requirements in a robust consent framework that are needed to provide a viable and functional service.

Principle 4: To achieve trusted, durable, and adaptable digital payments; any CBDC ecosystem must be secure and resilient to cyber, fraud and other operational risks.

Unlike physical bank notes, the G7 recognises that CBDCs are reliant on the infrastructure underpinning them and emphasise the importance of capacity planning, business continuity, disaster recovery planning, crisis simulation and playbook development to maintain the resilience of the CBDC infrastructure. Private and public players in the CBDC ecosystem may need to work together on their approach to operational resilience and cybersecurity, in line with national and international standards, to secure the resilience of the overall CBDC system.

Principle 5: CBDCs should coexist with existing means of payment and should operate in an open, secure, resilient, transparent and competitive environment that promotes choice and diversity in payment options.

The G7 considers that policies should be put into place to ensure competition and diversity of choice in payment markets to promote innovation. By providing an additional means of payment, CBDCs will enhance competition; however, it is also vital to ensure two-way interoperability between CBDCs and other payment methods. The G7 also acknowledges the varying roles that can be played by public and private players in the CBDC ecosystem in accordance with their comparative advantages; however, to protect consumers, it is emphasised that these services must be subject to regulatory oversight and should be carried out in a transparent and competitive manner.

Principle 6: Any CBDC needs to carefully integrate the need for faster, more accessible, safer and cheaper payments with a commitment to mitigate their use in facilitating crime.

It is crucial that CBDCs comply with anti-money laundering, counter-terrorist financing and counter-proliferation of weapons of mass-destruction obligations. Such safeguards should be built into the design of CBDCs and advancements in technology should be harnessed to accurately authenticate and verify transactions. CBDCs can offer opportunities in the improvement of information-sharing processes and increase the effectiveness of real-time monitoring and ex post facto investigations of payments and value transfer. The G7 also recognises that both public and private players have a role in this endeavour if illicit finance is to be countered effectively. Private players should be considered obliged entities and held responsible for reducing illicit finance in the CBDC ecosystem.

Principle 7: CBDCs should be designed to avoid risks of harm to the international monetary and financial system, including the monetary sovereignty and financial stability of other countries.

A fine balance must be drawn in allowing access to non-residents to CBDCs to facilitate cross-border payments and preventing unfettered access which could lead to currency substitution and loss of monetary sovereignty causing financial instability in either or both nations. The G7 highlights that countries vulnerable to such risks should work in collaboration to create and implement safeguards to minimise any negative impact. Public authorities must consider the implications of overseas access to their CBDCs and ensure ongoing multilateral cooperation for the resilience and stability of all CBDCs.

Principle 8: The energy usage of any CBDC infrastructure should be as efficient as possible to support the international community's shared commitments to transition to a net zero economy.

The design and implementation of CBDCs must account for energy usage from the start. With IT infrastructures currently using significant amounts of global energy, CBDCs can set a new standard by being energy-efficient and reliant on carbon-neutral / sustainable sources of energy without sacrificing their functional, performance and resilience goals.

Principle 9: CBDCs should support and be a catalyst for responsible innovation in the digital economy and ensure interoperability with existing and future payments solutions.

Public and private players must have clearly defined roles which will in turn support innovation. End-users, financial institutions, technology and other service providers and merchants should also be consulted in the development of CBDCs to account for a wide range of current and future needs. CBDCs themselves should support innovation by providing faster, cheaper, more inclusive, convenient and efficient payment solutions to reduce fragmentation amongst end-users and reduce concentrations within the payment landscape.

Principle 10: Authorities should consider the role of CBDCs in contributing to financial inclusion. CBDC should not impede, and where possible should enhance, access to payment services for those excluded from or underserved by the existing financial system, while also complementing the important role that will continue to be played by cash.

CBDCs should aim to be financially inclusive and must account for barriers to access to payment services such as cost, geography, connectivity, demographics, lack of or limited verifiable identification and low levels of literacy. The private sector must innovate solutions to limit the impact of these barriers while countries and international organisations must develop policies around financial literacy, digital literacy and access to digital infrastructure to support these efforts.

Principle 11: Any CBDC, where used to support payments between authorities and the public, should do so in a fast, inexpensive, transparent, inclusive and safe manner, both in normal times and in times of crisis.

CBDCs can make payments between authorities and the public more efficient by providing an additional payment infrastructure that could cover previously-unbanked populations and improved identity verification. However, this would require scale adoption of CBDCs for efficiency and require public authorities to use CBDCs in a legally defined manner to protect social values and individual rights.

Principle 12: Jurisdictions considering issuing CBDCs should explore how they might enhance cross-border payments, including through central banks and other organisations working openly and collaboratively to consider the international dimensions of CBDC design.

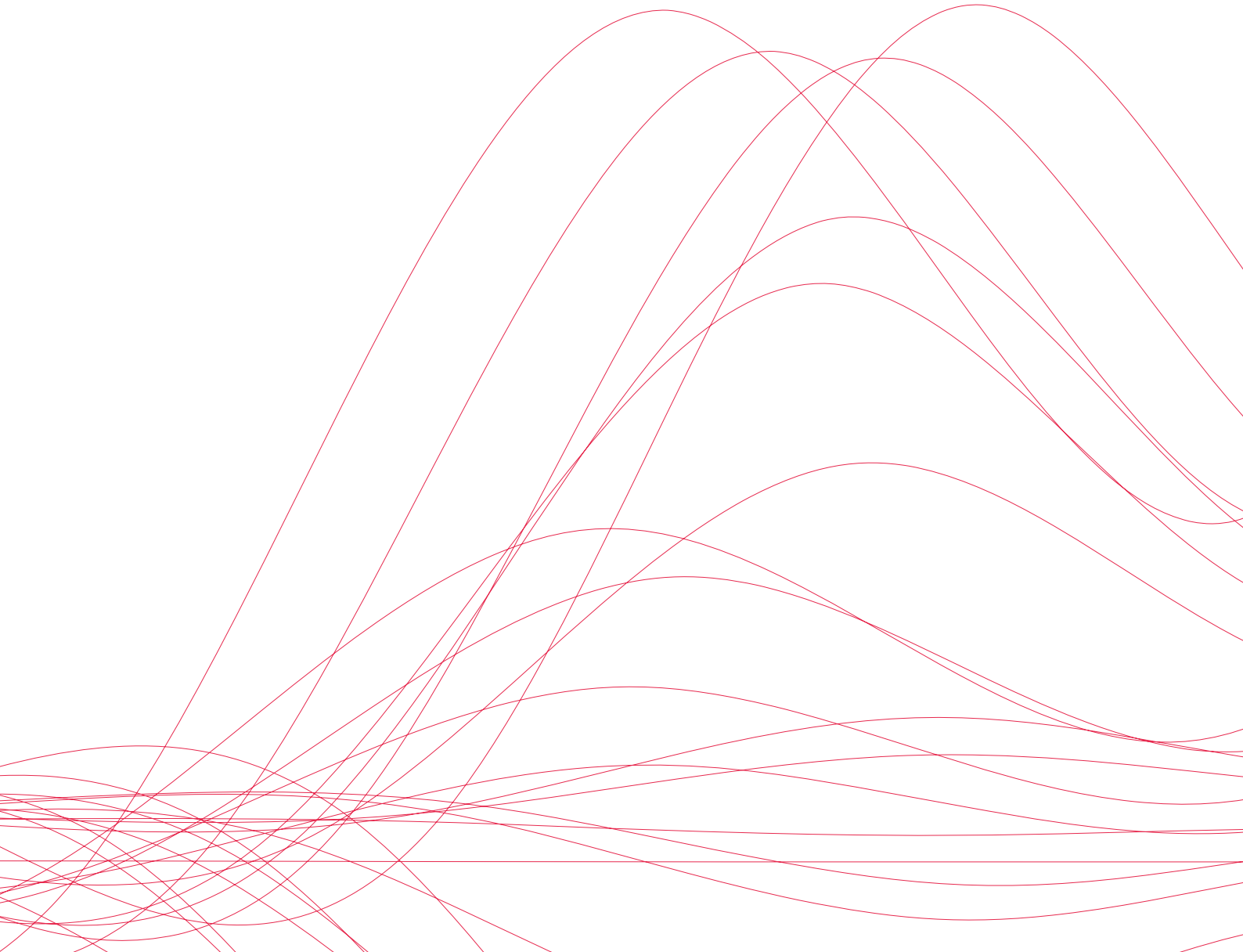
CBDCs could offer process improvement in cross-border and cross-currency interoperability and reduce the current problems of high costs, low speed, limited access and insufficient transparency associated with cross-border payments. International transactions by individuals and businesses could be made more efficient by providing for appropriate levels of overseas access to CBDCs to non-residents.

Principle 13: Any CBDC deployed for the provision of international development assistance should safeguard key public policies of the issuing and recipient countries, while providing sufficient transparency about the nature of the CBDC's design features.

The G7 recognises that there are limitations in using CBDCs for international development and the associated risks and opportunities are important considerations as the G7 considers the design of CBDCs as they aim to align them to principles of aid effectiveness and effective development cooperation.

Conclusion

No G7 authority has decided to issue a CBDC yet, but the joint statement highlights that the nations are continuing their consideration of the public policy implications of doing so. These principles provide an insight into the higher legal, regulatory and oversight standards CBDCs may be held to in order to minimise potential risks to financial stability. These principles also show that CBDCs are not solely a public sector endeavour but private players, including relevant international organisations, will also have a significant role to play in adhering to these principles as well as G7 central banks.



FSB Report on promoting climate-related disclosures

On 7 July 2021, the Financial Stability Board (FSB) published its "Report on Promoting Climate-Related Disclosures." Building on the framework recommendations provided by the Task Force on Climate-related Financial Disclosures (TCFD), the FSB called for the implementation of globally consistent standards for firms disclosing their climate-related financial risks.

The FSB has stressed that the need for comparable disclosures of climate-related financial risks is crucial for investors, financial authorities and other market participants to find the information they need from disclosing entities regarding the risks and opportunities presented by climate change. The FSB identified that current practices have led to a proliferation of third-party frameworks for climate-related disclosures that can lead to diverging market practices and standards. Global alignment on disclosures is a vital step in fostering standardisation and consistency.

The FSB has highlighted the IFRS Foundation's programme of work, which sets out a framework to create a standard for global sustainability reporting through clear governance and public supervision. The IFRS Foundation was also based on the TCFD framework, as well as on input from leading sustainability reporters, wider stakeholders and national and regional authorities.

Continuing its aim to achieve a consistent market approach, the FSB completed a survey of its members in the first half of 2021, investigating the differences between the approach of financial authorities to climate-related disclosure. The survey found that there were several areas where practices diverged. In particular, the FSB identified:

- potential inconsistencies of climate-related disclosure practices between financial authorities across both national and regional jurisdictions; and
- the need to strengthen the reliability of climate-related disclosures, such as through the use of regulatory or supervisory mechanisms to foster progress and third-party verification.

The FSB report sets out key recommendations to assist financial authorities in developing their frameworks, while bearing in mind relevant policy objectives and other legal and regulatory constraints. The report recommends that:

- Financial authorities should adopt TCFD Recommendations across all sectors for climate-related financial disclosures.
- Financial authorities should promote support each other across jurisdictions, share information and provide other assistance to implement climate-related disclosure frameworks to spread awareness of the key issues.
- Financial authorities should coordinate with each other, and provide a clear and consistent approach to guidance or requirements climate-related disclosures.
- Authorities should require third-party verification or assurance on such disclosures made by firms to ensure consistent approach is maintained across all sectors.

The FSB emphasised the need for continued coordination among financial authorities to accelerate progress in this area, with the FSB supporting the global coordination of these efforts.

In focus

Climate Financial Risk Forum Session
2 Guides released

On 21 October 2021, the Climate Financial Risk Forum (CFRF), co-chaired by the FCA and PRA, published its second round of 10 new guides (the Session 2 Guides) to assist the financial sector in developing its approach to climate-related financial risks and opportunities.

The CFRF originally published their guide to climate-related financial risk management on 29 June 2020 (2020 CFRF Guide). The guide was prepared by four working groups that each prepared chapters on risk management, scenario analysis, disclosures and innovation.

The Session 2 Guides build on the 2020 CFRF Guide and provide more guidance on risk management, scenario analysis, disclosure, innovation and climate data and metrics.

Risk Management – Risk appetite statements

The climate risk appetite statement (RAS) is a vital part of managing climate risk. The purpose of this guide is to offer advice on writing, implementing and maintaining an effective RAS. This guide focuses on a few of the specific risks that may affect climate risk appetites, namely:

- the impact of climate change on the firm through physical and transition risk;
- the impact of the firm on the climate through net zero (or other) alignment; and
- the most widely applicable financial risk categories, (eg credit risk).

This guide also suggests that climate RAS should consider transition risk, physical risk and alignment (to either net zero or some other science-based climate-related objective).

This guide encourages the adoption of a mechanism to ensure that there is a holistic view of climate risk, either a designated individual or a full team with formal responsibility so that ownership for climate risk is clearly established.

Risk Management – Use cases

The purpose of the Use cases guide is to provide further guidance on how to integrate risk appetites into the firm's risk management processes. This guide contains separate use cases for insurers, asset managers, retail banking and corporate banking.

Risk Management – Climate risk training

The Climate Risk Training guide aims to offer practical advice on the development and implementation of an effective climate risk training programme. The guide focuses on three key elements:

- key topics that form the basis of a climate risk training curriculum;

- importance of conducting detailed learning needs analysis to tailor training materials to effectively embed climate risk management across a firm; and
- factors needed to ensure success of a firm's climate risk training programme.

This guide suggests that it would be good practice to ensure that such training is linked to the firm's climate strategy, purpose and values.

Scenario Analysis – Implementation Guide

The Implementation guide builds on the Scenario Analysis Chapter in the 2020 CFRF Guide and provides further guidance for specific bank, insurance, and asset management use cases on identifying potential exposures to climate-related risks and assessing their financial impact. This guide also explains how scenario analysis can be used to measure portfolio alignment with the Paris Agreement and to aid portfolio construction. The guide advises that all of the approaches set out in the various case studies may be useful regardless of the specific industry.

Scenario Analysis – Data and tools providers spreadsheet

The Climate Risk Product Providers database is a list of current climate risk offerings that highlight the variety and scope of what is currently available. The database is designed to simplify research and decision-making around climate risk product procurement. The database presents information about the following specific climate risk products:

- Models
- Datasets
- Ratings
- Hazard maps
- Frameworks

The database is organised into the following searchable fields:

- Product format
- What risks are covered
- What geographies are covered
- A summary of input data sources
- A summary of outputs
- Information regarding product costs
- External links for further information

Disclosure – Case studies

This guide collected case studies from different types of organisations that would be of interest to financial institutions that are developing their own approaches to climate risk. These case studies suggest that climate concerns are increasingly integrated in risk management practices, investment research, stewardship, governance and policies and new approaches to investment portfolios and products. It was concluded that enhancing a firm's climate approach is an ongoing iterative process. Organisations will need to meaningfully involve their staff and adopt an integrated approach to develop credibility and coherence.

Disclosure – Managing legal risk

Financial institutions in the UK are expected to start facing legal and regulatory obligations to make climate-related financial disclosures from 2022. While financial institutions acknowledge the value and need for climate-related reporting, there are concerns about the current weakness of available climate-related data to support disclosures from the reporting institution's counterparties and data providers. There are concerns that disclosures will attract litigation and liability risks. This guide covers the areas of concern and potential litigation risks. The guide also provides guidance on managing risk of litigation and liability and offers best practice options for disclaimer wording that may be included in respect of disclosures.

Innovation – Commentary report

The Innovation Working Group (IWG) noted that the opportunities and upside potential of moving to a net-zero resilient economy have generally been underappreciated. The IWG concluded that firms need to have a capital allocation framework as well as a climate risk management framework. In relation to this issue, there needs to be actionable and scalable innovation which will require regulators to work closely with industry.

The IWG analysed and provided commentary on 11 innovation case studies that each could be categorised into three broad categories:

- Expand financing into the real economy
- Actions to finance transition assets
- Improve use of data and metrics

The case studies serve to demonstrate examples of innovative activities in the financial system that can be scaled and replicated by others.

Innovation – Case Study Videos

The IWG produced a series of videos on some of the case studies in the Commentary report.

LOCAL CLIMATE BONDS

Local climate bonds are an important financial innovation because they let ordinary people invest in local green projects such as solar, wind or biodiversity projects. If every local council raised money, they could raise billions. They also encourage discussion between communities and their local councils about the climate and potential solutions.

NET-ZERO NEIGHBOURHOOD FUNDING MODEL

Local authorities and cities have an important contribution to make to the net-zero agenda. This funding model helps local authorities fund retrofitting housing and making energy and transport improvements. The programme can also contribute to the health and regeneration of the neighbourhoods.

NEW ASSET ALLOCATION MODEL

Investments of GBP2.7 trillion are necessary to enable the UK to transition to a low-carbon economy. Currently, investors' models do not allow them to make the necessary investments so institutional investors set up the Institutional Investors Group on Climate Change (IIGCC) that delivered the Net Zero Investment Framework. This framework provides the tools for institutional investors to align capital towards the Paris Agreement.

COALITION FOR THE ENERGY EFFICIENCY OF BUILDINGS

Retrofitting buildings will play a significant role in reducing emissions. Green mortgages and property linked finance are major solutions that can make a meaningful impact on tackling climate change.

POSEIDON PRINCIPLES

50% of ship financing is currently made by parties that have signed up to the Poseidon Principles. The principles are Assessment, Accountability, Enforceability and Transparency. The Poseidon Principles would make the accurate measuring of ship's emissions and disclosing this information a covenant of financing documents.

SECURING COMMERCIAL DATA SHARING

The purpose of data sharing is to demonstrate that investments will deliver net zero and hold to account those implementing net zero solutions.

Climate Data and Metrics – Guide

The CFRF noted that financial institutions use a wide range of climate-related metrics. The CFRF intends to identify a common set of core metrics. These metrics are organised into five primary use cases:

- Transition risk
- Physical risk
- Portfolio decarbonisation
- Mobilising transition finance
- Engage ment

This guide presents an illustrative climate disclosure dashboard to provide practical guidance towards the development of a set of common and consistent climate metrics. The dashboard proposed that the use case metrics could be further placed in one of three categories:

- Basic: widely used; methodologies that are available today.
- Stretch: some use; methodologies at an early stage of development/acceptance in market.
- Advanced: forward-thinking and holistic but not yet widely developed or accepted.

The guide also analyses specific considerations for metrics that may be relevant for asset managers, banks and insurers, and provides real world examples (where available).

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