Exchange – International

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In Focus

Introduction

Welcome

DLA Piper's Financial Services International Regulatory team welcomes you to the 47th 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, Belgium and the US, plus international developments.

In Focus looks at the ban of certain Russian banks from the SWIFT messaging system, in response to the Ukraine conflict.

In the UK, we look at the new 'consumer duty' rule introduced by the Financial Conduct Authority (FCA), aimed at improving and prioritising customer protection in retail financial markets. We also discuss the Law Commission's advice on smart legal contracts, which includes guidance on whether the existing legal framework in England and Wales can support the use of smart legal contracts and whether there are any significant uncertainties or gaps in the law. In addition, we provide insights the new FCA rules on climate-related disclosures in the asset management sector.

In the EU, we look at the report of the European Supervisory authorities on digital finance, which examines whether the EU regulatory framework for financial services is fit for the digital age. We also inform you about the European Banking Authority's new guidance on the use of the limited network exclusion in payment services.

Belgium has recently put in place a new national framework for cryptoassets and we analyse what this means for market participants. In addition, we look at the Central Bank of Ireland's consultation on Irish property funds. In the US, we provide insights on the new draft principles intended to help guide US banks with more than USD100 billion in total consolidated assets in identifying and managing climate-related financial risks.

If you have any comments or suggestions for future issues, we welcome your feedback.

The DLA Piper Financial Services Regulatory Team
March 2022.

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UK

Changes to FCA Payment Services and E-Money Regulatory Regime

On 29 November 2021, Financial Conduct Authority (FCA) published amendments to the Regulatory Technical Standards on Strong Customer Authentication and Secure Communication (SCA-RTS).

The FCA also amended the guidance in "Payment Services and Electronic Money – our Approach" (Approach Document, now dated November 2021).

Background

The FCA recognised that the payments landscape and the open banking initiative has evolved since the Payment Services Regulations 2017 came into force.

In order to further prioritise making payments safe and accessible, as outlined in their 2021/22 Business Plan, the FCA commenced a consultation on open finance via a call for input.

Need for Change

Through this consultation, the FCA found two main barriers to the development and uptake of open banking:

- The requirement for customers to reauthenticate with their account servicing payment service provider (ASPSP, typically banks) every 90 days to continue accessing account information through a third-party provider (TPP).
- Use of existing customer interfaces that are not specifically designed for TPPs to access customer account information.

The amendments to the SCA-RTS will help remove these barriers.

What will be changed

The changes to the SCA-RTS include the following:

- Creating a new SCA exemption in Article 10A so that customers don't need to reauthenticate with their ASPSP every 90 days when accessing their account information through a TPP.
- Requiring certain ASPSPs to provide dedicated interfaces to enable TPP access to customer account information for retail and SME payment accounts.
- Amending requirements on providing interface technical specifications, testing interfaces and fallback interfaces by ASPSPs.
- Allowing ASPSPs with a deemed authorisation under the Temporary Permissions Regime to rely on an exemption from setting up a fallback interface granted by a competent authority in the EU.

The FCA has strongly encouraged ASPSPs to apply the new exemption from the obligation to carry out strong customer authentication as soon as practicable after it has come into effect. TPPs will need to reconfirm customer consent under Article 36(6) of the SCA-RTS no later than 4 months after the rules come into force.

The FCA is also updating the Approach Document to clarify the FCA's expectations of firms and ensure that the guidance on prudential risk management and safeguarding customer funds will enhance the resilience of firms.

FCA publishes draft consumer duty rules and guidance

The FCA published a further Consultation Paper (CP21/36) on the new Consumer Duty which includes draft rules and guidance. The emphasis behind the new Consumer Duty rules remains aimed at improving and prioritising customer protection in retail financial markets. We highlight the key points from the further Consultation Paper below.

Please also see our Briefing on the FCA's first consultation here for background.

Timing

The consultation remained open until 15 February 2022 and the FCA expects to confirm any final rules by the end of July 2022. The FCA is proposing to give firms until 30 April 2023 to fully implement the Consumer Duty.

The Consumer Principle – new Principle 12

The FCA decided that the wording for the new Consumer Principle should be "A firm must act to deliver good outcomes for retail clients".

The FCA is proposing to disapply Principles 6 (Customers' interests) and 7 (Communications with clients) where the Consumer Principle applies. Where the FCA regulates the provision of financial services to SMEs, which is covered on a sectoral basis, the Consumer Principle applies. Principles 6 and 7 will, for example, continue to apply for certain SMEs and wholesale business. However, the FCA considers that existing guidance on Principles 6 and 7 remains relevant to firms in considering their obligations under the Consumer Duty.

Scope

The Consumer Duty is to apply to all of a firm's activities. However, the FCA has confirmed that it will align the scope of the Consumer Duty with the existing scope of the FCA's sectoral sourcebooks (COBS, ICOBS, MCOB, BCOBS, etc.). The FCA recognised different sectors may face challenges in applying a single standard to retail clients.

Application to the Consumer Across the Distribution Chain

The Consumer Duty will apply across the distribution chain – product and service origination to distribution and post-sale activities – to all firms that could impact retail customer outcomes whether or not they have a direct relationship with the customer.

The FCA clarified that although, in general, while firms are only responsible for their own activities and do not have to oversee what other firms are doing, this will not be the case in all situations. For example when firms outsource activities to third parties, they remain responsible for compliance. In the context of the Consumer Duty, the FCA clarified that firms would be expected also to oversee the actions of others under the products and services outcome and price and value outcome, when they will be required to have regard to the wider distribution chain when developing a distribution strategy.

Taking its original proposal forward, the Consumer Duty is to apply to the wholesale market even if they do not have a direct relationship with the retail customer. The Consumer Duty will apply to firms that can influence the material aspects of a retail product or service, for example its design or operation. However, the FCA has said that it would only expect firms to be liable for their own activities and that in general, firms with a direct relationship with the end user will have the greatest responsibility under the Consumer Duty.

Application to existing products and services

The FCA confirmed that the Consumer Duty does not have a retrospective effect and does not apply to past actions by firms (which will be subject to the rules that applied at the time). However, the Consumer Duty will apply to existing products or services on a forward-looking-basis, whether or not they are still being sold to new customers.

Firms are expected to review existing products or services for compliance with all aspects of the Consumer Duty before the end of the implementation

period. If firms need to update customer terms and conditions, it will need to do so before it sells the product or service to new customers.

The cross-cutting rules

The cross-cutting rules originally proposed by the FCA required firms to:

- act in good faith towards retail customers
- take 'all reasonable steps' to
  - avoid causing foreseeable harm to retail customers; and
  - enable retail customers to pursue their financial objectives

Agreeing with responses to its previous consultation, the FCA decided to remove the requirement for firms to take 'all reasonable steps' as it wants firms to focus on acting reasonably to ensure good outcomes for their customers, as opposed to focusing on process and steps they need to take.

Th FCA also clarified that the Consumer Duty would not require firms to protect customers from unforeseeable harm; all poor outcomes; or risks that the customer reasonably understood and accepted.

No private right of action

The rules do not include a private right of action at this time, which would have had wide-reaching implications. The FCA has said it will keep this under review, but accepts the existing redress framework is likely to be a more appropriate route. The consultation emphasises working closely with FOS.

Monitoring and governance

The draft rules require firms to monitor and regularly review the outcomes that their customers receive, identifying harm or risk of harm and addressing the issues.

Although the FCA has not proposed to report on specific metrics, the FCA has included draft non-Handbook guidance which sets out the information that firms will need to collect to monitor outcomes and will need to be able to provide evidence of monitoring and resulting action, on request. The FCA has suggested a list of the types of information that firms may want to collect, these include, among others:

- Business persistence: analysis of customer retention records
- Distribution of legacy products/pricing and fees and charges
- Behavioural insights, e.g. customer interactions and drop-off rates
- Outcome reviews
- Testing customer experiences

SMCR – changes to COCON

The FCA has decided to amend COCON to reflect the higher standard of the Consumer Duty by adding a new rule requiring all conduct rules staff within firms to 'act to deliver good outcomes for retail customers' where their firms' activities fall within scope of the Consumer Duty. This would replace for activities within scope of the Consumer Duty, Individual Conduct Rule 4, which requires conduct rules staff to 'pay due regard to the interests of customers and treat them fairly'.

Implementation and cost

The FCA estimates that implementation costs will be very large – with one-off direct costs to be in the range of GBP688.6 million to GBP2.4 billion and annual direct cost to be in the range of GBP74.0 million to GBP176.2 million. The FCA has also noted that firms may suffer a loss of profits due to potential changes in product design and prices and have suggested that this loss of profits should be passed onto consumers.

The FCA expects cost of implementation will go to:

- understanding the Consumer Duty;
- performing gap analysis on their policies and processes;
- making relevant adjustments through change projects – implementing changes to existing policies and processes, and reviewing product design and pricing, and establishing the necessary monitoring etc;
- training their staff on the new requirements;
- IT costs for any system changes – to capture, analyse and store data or new management information; IT systems changes needed to improve customer experience; and
- monitoring and testing consumers outcomes.

Law Commission's advice on smart legal contracts: can the laws of England and Wales cope with this emerging technology?

As the Law Commission put it, smart legal contracts are expected to revolutionise the way business is conducted. In light of this potential paradigm shift, the Law Commission was asked to consider whether the existing legal framework in England and Wales can support the use of smart legal contracts and whether there are any significant uncertainties or gaps in the law.

Following a consultation between December 2020 and March 2021, the Law Commission published its advice to the UK Government on smart legal contracts on 25 November 2021. A cross-practice team of our lawyers provided responses to sections of the Law Commission's Call for Evidence earlier this year, and their analysis is cited in several places in the advice paper.

The advice concluded that the current legal framework in England and Wales is able to facilitate and support the use of smart legal contracts and that statutory reform is not currently required. Current legal principles can apply to smart legal contracts in much the same way as they do to traditional contracts, albeit with an incremental and principled development of the common law required in specific contexts. However, there are some traps for the unwary.

In this article, we consider the key features of the Law Commission's advice on smart legal contracts.

Key features of the Law Commission's advice

For the purpose of the Law Commissions' paper, a smart legal contract is defined as a legally binding contract in which some or all or the contractual obligations are defined in or performed by algorithmic code.

A smart legal contract may take one of the following forms: (i) written in natural language and performed by code; (ii) written solely in and performed by code; or (iii) a hybrid contract written in both natural language and in code, and performed by code.

In November 2019, the government-backed LawTech Delivery Panel's UK Jurisdiction Taskforce stated that smart contracts can, in principle, give rise to binding legal obligations. Taking this further, the Law Commission has now concluded that the ordinary rules of contract law in England and Wales can apply to smart legal contracts in much the same way they do to traditional contracts. Whilst there will be novel issues that may arise, there is sufficient flexibility in the common law of England and Wales to cater for these issues (albeit with the recognition that reform and / or regulatory intervention may be required in due course where the current legal framework does not suffice).

The advice focuses in particular on issues relating to contractual formation and interpretation, contractual remedies, and issues relating to determining applicable jurisdiction. These concepts should already be very familiar to legal practitioners, as they are key considerations to be borne in mind when considering entry into or performance of any contract. The advice considers how the current law in England and Wales relating to these concepts can be applied to smart legal contracts.

The Law Commission also notes that there are certain considerations that may be required when entering into a smart legal contract which parties to a traditional contract need not consider.

With this in mind, the Law Commission has sought to assist parties to smart legal contracts by providing a list of the issues parties may wish to consider and/or provide for in their smart legal contracts. Specifically, these are issues that the Law Commission considers may lead to disputes if not properly considered early by parties entering to a smart legal contract. The issues include:

- the role of code within the smart legal contract, and in particular whether the code is intended both to define contractual obligations and perform them, or just perform them;
- the relationship between any natural language and code, and, in particular, where a term is expressed

both in natural language and code which takes precedence in the event of a conflict;

- how risks are to be contractually allocated if, for example, there are inaccurate data inputs, bugs and coding errors, performance issues caused by external factors such as IT upgrades, or misunderstandings as to how the code will perform;
- the role of non-executable comments in the code and whether these should be considered to have the effect of contractual terms;
- whether to explain the workings of coded terms in natural language, and to make clear whether such language forms part of the contract, so that the parties' intentions regarding the proper performance of the code can be properly understood; and
- whether to include choice of court and choice of law clauses, by way of separate natural language agreement or comments in the code, so that there is an express choice should a dispute arise in relation to the smart legal contract.

Parties will need to give such issues careful thought before entry into a smart legal contract, and legal advisers will need to ensure they are familiar enough with these issues so that they can properly advise their clients.

Conclusion

The Law Commission's advice builds upon the work of the UK Jurisdiction Taskforce and provides further comfort that the legal framework in England and Wales is able to facilitate and support the use of smart legal contracts without immediate statutory reform.

The advice echoes the sentiments of Sir Geoffrey Vos, Master of the Rolls, in his lecture 'Cryptoassets as property: how can English law boost the confidence of would-be parties to smart legal contracts?' that "*English law is in a good position to provide the necessary legal infrastructure to facilitate smart legal contracts if, but only if, we try to keep any necessary reforms simple.*"

However, although the advice confirms English law can cope with smart legal contracts, as ever with legal concepts and documents the devil is in the detail, or perhaps more aptly put in this case, the devil is in the application.

FCA to strengthen financial promotions rules to protect consumers

On 19 January 2022, the Financial Conduct Authority (FCA) published its Consultation Paper (CP 22/2), in which it proposes to significantly strengthen the rules on the promotion of high-risk financial products. This Consultation Paper forms part of the FCA's Consumer Investments Strategy, published in September 2021, which aims to reduce the number of consumers who are investing in high-risk products that are not aligned to their needs.

In publishing CP 22/2, the FCA built on its earlier Discussion Paper (DP21/1) (published 29 April 2021), which highlighted three areas where regulatory changes could be applied to protect consumers from harm when investing in high-risk / speculative financial products. These were:

- the classification of high-risk investments;
- the segmentation of the high-risk investment market; and
- the responsibilities of firms which approve financial promotions.

Crucially, the FCA confirmed that any new rules on financial promotion will extend to 'qualifying' cryptoassets. The FCA's announcement came a day after the Treasury's Cryptoassets Promotion: ***Consultation response***, which stipulates that, in order to combat significant consumer risks created by misleading advertising and a lack of suitable information in the cryptoassets market, the Government will extend the current financial promotion regime to cover 'qualifying' cryptoassets (which broadly captures cryptoassets that are "fungible" and "transferable"). Behavioural research conducted by the FCA shows that cryptoassets pose a severe risk to consumers, particularly younger investors: young people are more exposed to aggressive online advertising through social media, and the fact that high-risk investment products are less suitable, given that nearly two thirds (59%) claim that a significant investment loss would have a fundamental impact on their current or future lifestyle.

Due to its concerns relating to online cryptoasset advertising, the FCA launched its GBP11 million InvestSmart campaign, together with its first ever TikTok video and Instagram live session in October 2021, targeting its "don't get played" message at younger, higher-risk investors. The FCA also established the Unregistered Cryptocurrency Businesses List, designed to help consumers identify cryptoasset firms that appear to be continuing business in the UK but are not registered with the FCA or have not sought such registration.

Over the past year, the FCA has developed an increasingly combative stance against crypto-providers' online advertising. In January 2021, the FCA gave a stark warning that "***investing in cryptoassets, or investments and lending linked to them, generally involves taking very high risks with investors' money. If consumers invest in these types of product, they should be prepared to lose all their money***." The FCA has supported this stance with active intervention against cryptoasset adverts which may be misleading. In June 2021, the FCA issued a consumer warning about Binance Markets Limited, announcing to consumers that Binance Markets is not permitted to undertake any regulated activity in the UK, and cautioned investors to be wary of its online advertising for cryptoassets. One month later in July 2021, the FCA warned investors and consumers about CoinBurp, warning that their promotions around token issuance were misleading and that CoinBurp had so far failed to register itself under Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017. The FCA warned that consumers would have very limited financial recourse if they lost their money in one of these investments.

Strengthening of the financial promotions regime and the inclusion of cryptoassets

The current financial promotions regime consists of:

- Section 21 of the Financial Services and Markets Act 2000 (FSMA), which sets out ***the financial promotion restriction***. This restriction is broad in scope, and provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity or claims management activity. Breaching section 21 FSMA is a criminal offence.

- The FSMA (Financial Promotion) Order 2005 (FPO), which includes a number of exemptions from the financial promotion restriction. These permit an unauthorised person to communicate a financial promotion in certain circumstances and subject to certain conditions.
- The FCA's rules which apply to authorised firms when communicating or approving financial promotions including, for example, the requirement that financial promotions must be fair, clear and not misleading; this requirement is set out in the FCA's rulebook, in the Conduct of Business Sourcebook (COBS) 4.

Under CP 22/2, the FCA is proposing to strengthen the financial promotions rules for high-risk investments. 'High-risk investments' refer to those investments which are subject to marketing restrictions under the FCA. This includes investment based-crowdfunding (IBCF), peer-to-peer (P2P) agreements, other non-readily realisable securities (NRRSs), non-mainstream pooled investments (NMPIs) and speculative illiquid securities (SISs).

As per the Treasury's recommendation (see above), cryptoassets will also be classified as 'High-risk Investments' and brought within the scope of the financial promotion rules for the first time. Part of the FCA's consultation under CP 22/2 is to decide upon how best to categorise cryptoassets once they are brought into the financial promotion regime. Cryptoassets are notoriously difficult to categorise and are in a constant state of evolution – broadly speaking, they are typified by a digital asset or token that depends on cryptography and exists on a distributed ledger (i.e. blockchain). Cryptoassets can be categorised into three main categories: ***payment tokens/coins***, which are predominantly used as a medium of payment (such as Bitcoin); ***investment tokens/security tokens***, which are tied to an underlying security and can provide profit-rights, such as rights to dividends in a digital bond; and ***utility tokens*** that serves a use case within a specific ecosystem, and may grant access to a service or product (e.g., Binance Coin, which provides users with a discount in trading fees).

For now, the FCA proposes to apply the same rules to cryptoassets as are currently applied to NRRSs and P2P agreements (collectively this category will be referred to as 'Restricted Mass Market Investments'). As such, financial promotions relating to cryptoassets will need to comply with the existing financial promotion rules in COBS 4, including the requirements for the promotion to be clear, fair and not misleading, and will be subject to strengthened rules regarding customer journey (please see below).

The FCA has clarified that 'Direct Offer' Financial Promotions of qualifying cryptoassets made to self-certified sophisticated investors will remain unrestricted under the FPO. This would ensure that only restricted, high net worth or sophisticated investors could respond to online cryptoasset financial promotions.

Under the proposed rules, the FCA will seek to bolster the financial promotions regime in three core ways:

1. Improving its classification of high-risk investments: The FCA wants to ensure that a consumer's investment suits their risk tolerance. As such, the FCA intends to rationalise its rules under COBS 4 regarding 'Restricted Mass Market Investments' and 'Non-Mass Market Investments', particularly given that cryptoassets will now be included in such categorisations, to provide clarity to consumers in what investments they should/ should not be making.
2. Tightening the 'consumer journey':
   The FCA will bolster consumer protection by stipulating that any advert offering high-risk investments must implement a robust questionnaire for consumers to complete before they would be able to access the investment. In particular, the FCA wants to prevent simple questions that consumers can easily click through without really understanding the investment risks involved.

   Moreover, qualifying high-risk investments will have risk warnings imposed on their ads, and may be banned from promoting investment incentives such as 'new joiner' or 'refer-a-friend bonuses'.
3. Strengthening firms that approve and communicate financial marketing Concurrently, the FCA is developing proposals for a new regulatory gateway under section 21 FSMA, known as the 's21 gateway'. These gateways allow authorised firms (known as 's21 approvers') to approve the financial promotions of unauthorised firms.

   Given that s21 approvers play an important role in enabling unauthorised issuers of high-risk investments to reach consumers, the FCA intends to develop a more robust regime for s21 approvers, to ensure they have the relevant expertise and understanding of the investments being offered.

Next steps

The deadline for feedback to CP 22/2 is 23 March 2022, with a subsequent Policy Statement and final Handbook rules expected to be published in summer 2022. The FCA proposes firms have three months from the publishing of final rules to comply with the new requirements for the consumer journey and the new requirements for s.21 approvers.

In the meantime, the FCA will continue with its InvestSmart campaign and their ongoing Supervisory and Enforcement action to address harm in the mass-marketing of speculative illiquid securities.

Payment Systems Regulator launches consultation on new rules for Card Acquiring Services

On 26 January 2022, the Payment Systems Regulator (PSR) published Consultation Paper 22/1 on proposed remedies to address the areas of concern in the card acquiring market (CP 22/1), particularly in respect of SME merchants (with a turnover of up to GBP50 million a year).

CP 22/1 follows the publication by the PSR of its final report on its market review into the supply of card-acquiring services. We have previously summarised this final report on FinBrief.

In CP 22/1, the PSR is proposing four remedies to ensure that merchants when using card acquiring services have:

- Greater transparency to help merchants understand pricing elements and make purchasing decisions;
- Access to comparison tools such as price comparison websites;
- Greater engagement to help merchants when their contracts are due for renewal; and
- Ability to change providers easily.

Purpose of these remedies

Every time somebody makes card payment, the merchant uses card acquiring services to accept that payment. According to UK Finance, in 2020 there were 157 million cards issued in the UK and consumers made 15.5 billion debit card payments.

The PSR focus is on making card acquiring services work well for merchants (particularly merchants with lower turnovers and amongst them, SMEs) and ultimately for consumers.

Market review into the supply of card-acquiring services

In its final report on its Market Review, the PSR concluded that the supply of card-acquiring services does not work well for merchants with turnover up to GBP50 million per annum for the following three reasons:

Acquirers of card transactions and independent sales organisations (ISOs) do not typically publish their prices for card-acquiring services. This makes it difficult for merchants to compare prices;

- The indefinite duration of acquirer and payment facilitator contracts for card-acquiring services may be relevant to merchants not considering switching or searching for alternative providers regularly;
- Point of Sale (POS) Terminals and POS terminal contracts prevent or discourage merchants from searching and switching providers of card acquiring services. This may occur because a merchant cannot use their existing POS terminal with a new card acquirer and/or the merchant may incur a significant early termination fee when cancelling their terminal contract.

Remedies under consideration

In CP 22/1, the PSR states that it is considering the following 4 remedies and is seeking feedback from industry on their need and effectiveness.

The PSR also confirmed that it will not be pursuing direct intervention in the pricing structures of card-acquiring service providers or the imposition of mandatory fixed-term card-acquiring contracts as previously contemplated in the final report of the Market Review.

1. Summary Information Boxes

The PSR is proposing the introduction of summary information boxes which display both price and non-price factors in a standardised format. There will be bespoke and generic boxes.

- Bespoke summary boxes would be provided by acquirers and ISOs to each of their merchant customers and would contain tailored information about pricing and options to migrate to other tariffs or switch providers;
- Generic summary boxes would be provided to all customers and potential customers on acquirer and ISO websites. This would enable merchants to quickly assess pricing and service options across a range of acquirers.

In CP 22/1, the PSR note that summary information boxes have led to better outcomes in other sectors, for example key fact illustrations for mortgage providers and key information documents for packaged retail investment and insurance products.

2. Stimulating Digital Comparison Tools (DCTs) for merchants

Like summary information boxes, DCTs have the potential to provide merchants with comparable information on price and other service elements in one place which should enable merchants to shop around for card-acquiring services.

DCTs are not well established in the card-acquiring market. The market itself makes it difficult for DCTs to operate, for example due to pricing structures varying significantly between providers.

Whilst the PSR does not propose to directly intervene in pricing structures of card-acquiring service providers, it is considering measures to improve the availability and accessibility of card-acquirer and ISO pricing information to third party intermediaries. This may involve:

- Provision of pricing and other comparable service information to DCTs by providers of card-acquiring services to enable the creation of price comparison tools;
- Collation and presentation of comparative pricing and other service data updated regularly in formats which are easily usable by DCTs; and/or
- Enabling merchants to share their acquirer transaction data with third parties so this can be used by DCTs to assess merchant options, where merchants want to do this and have consented to it.

3. Trigger Messages

In CP 22/1, the PSR suggests that merchant search and switch activity could be improved if card-acquirers provide information to them at specified times to trigger or prompt engagement. Switching can lead to both price and non-price outcomes, for example improved quality of service and customer support.

The PSR is seeking industry views on the timing, content, and method of delivering trigger messages.

Trigger messages used in energy markets, for electronic communications and for pay-TV providers as well as for current accounts and home insurance policies suggest to the PSR that these messages would be helpful to small and medium-sized merchants purchasing card-acquiring services.

4. Addressing Barriers to switching between card-acquiring services which arise from POS terminal leases

In CP 22/1, the PSR state that it may be necessary to address barriers to switching directly – for example by introducing a prohibition on contract roll-overs if they were found to be preventing merchants from switching between card-acquiring services.

At this stage, however, the PSR is focusing on addressing technical barriers to switching POS terminals. For example, current industry practice makes terminal porting difficult for a number of reasons including:

- Physical reconfiguration of terminals is required for them to work with a new card-acquiring service; and/or
- Terminals require certification by each card-acquirer for each payment scheme they operate. Also, use of a terminal with a new card-acquirer must be covered by an existing or new certification.

Examples of technical solutions which could fully or partly address this concern are:

- Replacement of terminals by POS terminal lease providers to support merchants switching between card-acquiring services;
- Portability of POS terminals when a merchant switches between card-acquiring services. The PSR committed to consider common interoperability standards to support this.

Consultation Next Steps

The deadline for responses to CP 22/1 is 5pm on 6 April 2022.

After the consultation, the PSR will consider the information submitted and publish a provisional decision which will include draft remedies.

ESG: New FCA rules on climate-related disclosures

The Financial Conduct Authority (FCA) has published its final rules on climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers in Policy Statement 21/24 (PS 21/24). The new obligations already apply in respect of some of the largest firms from 1 January 2022. The requirements are aligned with the widely recognised Taskforce on Climate-related Financial Disclosures (TCFD) recommendations. In this note, we will consider some of the implications of these changes and how market participants can best prepare for their implementation.

Sustainability is, undoubtedly, a key focus of the UK regulator for the years ahead and we are assisting our clients to navigate the evolving regulatory environment. The new rules follow the FCA's earlier consultation on the topic, which you can read more about here. The FCA aims to ensure that firms manage climate-related risks and opportunities in a more transparent manner. Ultimately, the objective is to drive more investment towards greener projects and activities, in line with the UK government's broader policy of 'greening finance' and supporting sustainable investing. It is recognised that the system needs to promote on the one hand, open provision of high quality information on climate risk in business and operations; and on the other hand to generate trust and verifiable substance in green and other sustainability related investment products, to enable this.

The FCA is introducing a new Environmental, Social and Governance (ESG) sourcebook of the FCA Handbook, setting out rules and providing guidance for asset managers and certain FCA-regulated asset owners for making disclosures consistent with the recommendations of the TCFD.

Specifically, asset managers and certain FCA-regulated asset owners will be required to make mandatory disclosures on an annual basis, with the reporting scope being two-fold, both:

- Entity level – an entity-level TCFD report explaining how the firm takes climate-related risks and opportunities into account when managing or administering investments on behalf of clients and consumers; and
- Product or portfolio level – a baseline set of consistent, comparable disclosures on the firm's products and portfolios, which must include a core set of metrics.

The new ESG sourcebook includes useful guidance on determining whether disclosures are consistent with the TCFD's recommendations and the rules. We have drawn out some of the salient guidance points below.

Scope of application & timing

The new rules apply to UK firms in relation to their "TCFD in-scope business". This includes core fund management activities, but also the MiFID investment service of portfolio management. Firms should carefully consider the scope of their permissions to come to a view whether they are caught by the new regime.

Firms with less than GBP5 billion in assets under management (AUM) or administration (calculated on a 3-year rolling average basis, assessed annually) are excluded from scope of the regime.

The new rules will come into effect in two phases. This first phase will capture asset managers with over GBP50 billion in AUM (currently 34 firms) and asset owners with assets over GBP25 billion (currently 12 firms). With regard to asset managers, this is the same test as the one for determining whether a firm is an 'enhanced scope Senior Managers and Certification Regime (SM&CR) firm', so firms should generally be familiar with the conditions. The requirements are already applicable in respect of the largest firms, since 1 January 2022, with the first set of disclosures being required by 30 June 2023.

The rules will come into effect for smaller firms one year later. It is expected that, once fully into effect, the requirements will apply to 140 asset management and 34 asset owner firms, representing GBP12.1 trillion in assets under management (AUM) and administered in the UK market – which broadly covers 98% of both the UK asset management market and assets held by UK asset owners.

Guidance as to TCFD compliant reporting

In-scope firms should familiarise themselves with the new ESG Sourcebook as well as the TCFD recommendations for preparing their reports. Firms are also expected to take "reasonable steps" to comply with the TCFD's Guidance for all Sectors and Supplemental Guidance for Asset Managers and Asset Owners (which can be found in the TCFD Annex) as well as the TCFD Technical Supplement on Measuring Portfolio Alignment and the TCFD Guidance on Metrics, Targets and Transition Plans.

The entity-level report must contain climate-related financial disclosures concerning all the assets under management in relation to in-scope business. Where a firm decides to take a materially different approach in respect of a specific investment strategy, asset class or product, it must make a relevant disclosure. The report must also explain the firm's approach to climate-related scenario analysis (which must be accompanied by quantitative examples where possible) and how this is applied in its investment and risk decision-making process.

Where appropriate, firms may cross-refer to entity-level reports made by other members of their group, provided that these include climate-related disclosures consistent with the TCFD's recommendations. UK firms should, however, be aware that not all jurisdictions have adopted rules regarding TCFD-aligned reporting.

The entity-level report must be published in a prominent location on firms' websites. With regards to product-level reports, client communications (such as annual fund reports and periodic client reports) must generally include a cross-reference and hyperlink to the product-level report. In certain circumstances where public disclosure is not deemed appropriate, firms will need to make "on-demand" TCFD product-level reports addressed to specific clients.

Additional considerations for all firms

It is important to remember that the ESG sourcebook is only one set of requirements that may be relevant to firms with a sustainability-linked focus. All firms should consider the broader requirements under the FCA Handbook and how these apply to ESG-related disclosures both at the pre- and post-authorisation stage. This includes the general obligation to communicate information to clients in a way which is 'clear, fair and not misleading'. Marketing material, client communications and application for authorisation documents (including regulatory business plans) should be appropriately tailored to meet the relevant FCA standards.

FCA strategic review of retail banking business models

On 20 January 2022, the Financial Conduct Authority (FCA) published a strategic review of retail banking business models (Strategic Review).

The Strategic Review updated the FCA's previous strategic review that was published in 2018 and explored new developments since 2015.

The Strategic Review found that, despite the impact of the Covid-19 pandemic, digital challengers had continued to increase competition in the retail banking sector. In fact, the pandemic had accelerated the move to digital channels and the digital transformation of the incumbent banks. This transformational digitalisation has increased choice and lowered costs for banking customers – including retail consumers and small businesses.

In this article, we summarise the key findings of the Strategic Review.

Increasing Competition

The large banks such as LBG, Barclays, HSBC and NatWest are increasingly seeing their historical advantages eroded due to innovation, digitalisation and changing consumer behaviour. The gap in profitability between large banks and digital challengers has continued to reduce.

Digital Challengers

Traditionally, new entrants in the banking sector suffered from high barriers to growth which made it expensive and slow to build market share.

Digital challengers currently make up 8% of the market for personal current accounts (PCAs). They have been able to attract customers by offering innovative mobile applications which make banking easier and more convenient. Incumbent banks have copied certain digital innovations, such as the freezing of bank cards or access to forgotten Personal Identification Numbers via mobile applications.

Competition in the Mortgage Market

Competition in the mortgage market has intensified leading to falling yields. Increased broker usage has led to lower levels of standard variable rate mortgages which has also reduced yields. Smaller banks and building societies have found it difficult to compete with larger firms in low-risk lending which has led some firms to exit the market while others focus on high-risk lending.

Consumer Credit Yields

The FCA's overdraft remedy came into force in April 2020 which has led to a decline in unarranged overdraft yields. Covid-19 has also reduced demand for consumer credit. The FCA continues to intervene to protect consumers with temporary support measures such as payment deferral guidance.

Micro-Business Lending

The existing trends of major banks reducing their lending to Small and Medium Sized Enterprises (SMEs) were reversed during the pandemic. However, some smaller banks have taken advantage of the pandemic to grow their share of SME accounts and lending.

Impact on Consumers and Small Businesses

Larger banks are increasingly adopting digital innovation in PCA banking to compete with the digital challengers. This has improved outcomes for consumers and small businesses leading to increased mobile banking customer satisfaction.

Implications of the Strategic Review for the FCA

The FCA remains committed to further interventions to increase competition and innovation in retail banking. This includes Open Banking and Open Finance in order to make it easier to share consumer data in a secure and interoperable environment.

The FCA accepts that innovation has risks and new firms can fail. The FCA is committed to ensuring an appropriate balance between supporting innovative firms whilst also making sure that firm exit is orderly and does not create concerns about consumer protection.

The FCA continues to work on ensuring fair treatment for consumers. The FCA Is currently consulting on a new Consumer Duty and has published Guidance on the protection of vulnerable consumers.

The FCA is also monitoring how banks are implementing new business models and supervising retail bank activity that may affect consumers.

Ireland

Central Bank of Ireland consultation paper on Irish Property Funds

On the 25 November, 2021, the Central Bank of Ireland (Central Bank) issued a consultation paper 145 (Consultation Paper) to industry in relation to a proposal to: (1) introduce macroprudential limits on leverage and (2) provide regulatory guidance to reduce the potential for liquidity mis-matches in AIFMD[1] compliant property funds, which are Irish-authorised and investing over 50% directly or indirectly in Irish property.

A. Background

Following a period of analysis of the impact of the Irish real estate sector, including property funds, on the overall financial stability of the Irish economy, the Central Bank issued a Financial Stability Note in February 2021 in which it was noted "***that property funds' investment in Irish commercial real estate has brought risks as well as benefits, which supports the need to explore possible macroprudential policy interventions***".

Over recent years, there has been significant growth in the use of Irish authorised investment funds for the purposes of investing in Irish commercial real estate (CRE). The Central Bank has noted that, given its systemic importance, any unexpected and/or significant instability in the Irish CRE market has the potential to create adverse consequences and/or macroeconomic effects for the wider Irish economy.

With the aim of addressing potential financial stability risks in the longer term and to ensure that the sector is better able to absorb, rather than amplify, adverse shocks in future times of stress, the Central Bank has now issued the Consultation Paper with its proposals around the introduction of macroprudential policy interventions in this sector. The Central Bank is of the view that this "***in turn will better equip the sector to continue to serve its purpose as a valuable and sustainable source of funding for economic activity***." In particular, the Central Bank has identified and focussed upon two key potential sources of financial vulnerability, namely, leverage and liquidity mismatch in Irish-authorised property funds, which it believes will complement existing regulatory requirements.

B. Proposed measures to address leverage in certain Irish Property Funds

As part of its analysis of the Irish property sector, the Central Bank has identified in the Consultation Paper that:

- there is significant variation in leverage levels across Irish property funds;
- a cohort of property funds have elevated levels of leverage; and
- the average value of total loans to the value of total assets in Irish property funds is approximately 46%; however there are significant differences across the sector in Ireland and the Irish average exceeds the whole property fund sector across Europe.

These factors create the risk that highly-leveraged property funds may breach their loan covenants (including leverage thresholds), resulting in voluntary or compulsory asset sales in an illiquid market resulting in the amplification of stress in the CRE market and wider market instability.

IMPACTED IRISH PROPERTY FUNDS

The Leverage Limit (defined below) would apply to all authorised property alternative investment funds (AIFs) in Ireland, which invest over 50% directly or indirectly in Irish property assets (Property Funds).

New Property Funds will be required to adhere to the Leverage Limit upon authorisation, whilst the Central Bank proposes to provide a three-year transition period for existing Property Funds with leverage levels above the proposed Leverage Limit to ensure that those funds have appropriate time to adjust their portfolio in a gradual and orderly manner.

PROPOSED LEVERAGE LIMIT

As detailed in the Consultation Paper, and similar to leverage limits for Property Funds in place in other countries, the Central Bank now proposes to introduce a 50% limit on the ratio of Property Funds' total loans to their total assets (or its equivalent applying the AIFMD gross or commitment methodologies) (Leverage Limit).

[1] Directive 2011/61/EU.

The Leverage Limit will apply to all types of loans, including loans from affiliated parties and shareholders, with a view to reducing the potential for regulatory arbitrage by increasing leverage through unregulated affiliated entities.

Leverage Limits will be determined by the Central Bank based on each Property Fund's regular regulatory reporting of asset and liability values. Property Funds with levels of leverage close to, or above the Leverage Limit would be issued with a Leverage Limit by the Central Bank, which would also be notified to ESMA.

Given the significant variation in leverage levels in Property Funds, the Central Bank states that it will consider feedback from stakeholders "***on the proposed calibration of the limit carefully***". In addition, it is proposed that the Central Bank will have the power to temporarily remove or tighten the Leverage Limits, where it deems appropriate.

C. Proposed measures to address liquidity mismatch in certain Irish Property Funds

Following its analysis of Irish property funds, the Central Bank has "observed significant variation in the redemption terms of Irish property funds, which cannot be explained fully by differences in the liquidity of their assets". The Central Bank is of the view that liquidity mismatch is evident for a significant subset of Irish property funds and that additional regulatory guidance (Guidance) is required, which will be specific to Property Funds, but which may have more general value to other types of AIFs when interpreting regulatory requirements on liquidity risk management.

PROPOSED GUIDANCE ON LIQUIDITY MANAGEMENT

Despite existing regulatory requirement for Irish authorised AIFs, including Property Funds, to align their redemption policies with their investment policies and strategies and the liquidity profile of their investments, the Central Bank is of the view that it is appropriate to introduce the additional regulatory Guidance for Property Funds on aligning their redemption terms with the liquidity of their assets.

Detail of the draft Guidance is set out in Annex 1 to the Consultation Paper and includes the following key proposals:

- Irish Property Funds should typically be authorised as either closed-ended or open ended with limited liquidity.
- The board of the alternative investment fund manager (AIFM) (and also the board of the Property Fund, where appropriate) should consider and document the structure/liquidity status that is most appropriate for the Property Fund, taking into consideration the asset class(es), the availability of a secondary market and whether redemptions could be satisfied without the need to dispose of large portions of the portfolio held by the Property Fund.
- Redemption policies should be reviewed to ensure that they align with the liquidity profile of the assets for open-ended with limited liquidity Property Funds.
- AIFMs must take into account the liquidity of real estate assets under both normal and stressed market conditions when considering redemption terms for Property Funds.
- Liquidity management tools (LMTs), which are complementary to the redemption policy and align with the liquidity profile of a Property Fund's assets, should be available to the AIFM to permit it to manage liquidity risk, where appropriate. LMTs should, however, not be excessively relied upon. Please also refer to our publication on the European Commission's proposed reforms of AIFMD, which include new proposals around the use of LMTs in AIFs.
- In relation to liquidity timeframes, the Guidance proposes that:
    - Property Funds should have appropriately balanced liquidity timeframes which include lengthened notification periods for redemption requests and settlement periods for the payment of redemption monies to investors.
    - Property Funds should provide for a liquidity timeframe of at least 12 months, taking into account the nature of the assets held. The Central Bank notes that this will "***assist in ensuring that the redemption terms of the property fund align with the liquidity of the assets held in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors***."
    - Property Funds that cannot dispose of assets within the minimum liquidity timeframe should consider having longer liquidity timeframes in place.

Further growth expected for Ireland as a domicile for private market/ closed-ended funds following welcome regulatory clarification regarding non-discretionary advisors

On 20 December 2021 the Central Bank of Ireland (Central Bank) published an updated version of its AIFMD Q&A (Q&A) which included, amongst other updates, the Central Bank's expectations in respect of the appointment of a non-discretionary investment advisor (Investment Advisor) providing services to a qualifying investor alternative investment fund (QIAIF). QIAIFs are Irish alternative investment funds, regulated by the Central Bank and marketed to 'qualifying investors', which include sophisticated and institutional investors who meet minimum subscription requirements.

The Q&A provides welcome clarification to firms considering the establishment of a QIAIF with a private equity strategy or otherwise investing in physical assets (e.g. real estate) which do not qualify as financial instruments under MiFID. It is anticipated that this regulatory clarification will facilitate further interest in Ireland as a domicile for private market and closed-ended funds and, in particular, using the recently modernised investment limited partnership as the vehicle to house such products.

Regulatory Clarification

The Q&A confirms that delegation of non-discretionary activities to an Investment Advisor is permitted, including in circumstances where the Investment Advisor will receive a higher proportion of fees than other service providers to the QIAIF. Such delegation arrangements will be permitted provided that the Investment Advisor is performing a role that is advisory in nature (i.e. it has no discretionary investment management powers) and the alternative investment fund manager (AIFM) is able to evidence this position where requested by the Central Bank.

The Central Bank will also require that the prospectus/ offering memorandum for the QIAIF incorporates the following disclosures regarding the role of the Investment Advisor, fees payable and oversight controls:

- **Details of the Investment Advisor, and a description of the services it provides**, must be appropriately disclosed in the QIAIF's prospectus/ offering memorandum. The Central Bank acknowledges in the Q&A that, where a QIAIF is operating private equity strategies or is otherwise invested in physical assets which do not qualify as financial instruments under MiFID, an Investment Advisor may provide a range of services to the AIFM–or an investment manager – in respect of that QIAIF (for example, with respect to a geographical location or asset type, which may not be required for other investment strategies). Such services may include activities relating to identification and origination of investment proposals, due diligence and other operational activities relating to the assets or proposed investments of the QIAIF.
- A **description of the role of the AIFM with respect to its ongoing oversight and review of services** should be provided by the Investment Advisor, including details on how the AIFM will discharge its obligations regarding delegation arrangements as set out in AIFMD Level 2.
- A **description of how any fees of the Investment Advisor are accrued and paid** must be disclosed in the prospectus/offering memorandum. The Central Bank recognises that the services provided by an Investment Advisor may not be required for other investment strategies and, for this reason, the

fees paid to the Investment Advisor may appear disproportionately greater than those paid to other service providers of the QIAIF. The Central Bank requires that where such fees are payable directly from the assets of the QIAIF, the maximum fee and the potential to pay out of pocket expenses on normal commercial terms are disclosed in the QIAIF's prospectus/offering memorandum. Where a single figure is disclosed in the prospectus/offering memorandum that covers all of the fees payable out of the assets of the QIAIF, the prospectus/offering memorandum should disclose that the Investment Advisor will receive a fee greater than typically paid to a non-discretionary investment advisor. Such disclosure should also cross-reference details of the services that the Investment Advisor is providing to the QIAIF in order to provide context for its fee.

Belgium

A new regulatory framework for the provision of certain crypto-asset services in Belgium

In February 2022, Belgium introduced a new legal framework regulating the provision of certain services related to virtual assets in Belgium. This initiative runs ahead of the regulatory initiatives at the European level, notably the "MiCa" proposal, and significantly strengthens the supervision on professional services related to virtual assets.

As the regulatory framework provides for only limited transitional measures, immediate action by virtual asset service providers is required.

This article summarises the new Belgian regulatory framework.

The new Belgian regulatory framework applicable to virtual asset service providers (VASPs)

The fifth AML Directive (AMLD V)[2] broadened the personal scope of regulatory requirements under anti-money laundering and terrorist financing rules and regulations (AML/CFT Laws and Regulations)[3] to "providers of exchange services between virtual currencies and fiat currencies" and "custodian wallet providers" (together referred to as virtual asset service providers or VASPs).

Belgium implemented AMLD V and its predecessors in the Law of 18 September 2017 on the prevention of money laundering and terrorist financing, as amended from time to time (the AML Act).[4]

In summary, the AML Act provides that:

- VASPs are subject to AML/CFT laws and regulations, including know-your-customer (KYC) due diligence requirements;
- it is prohibited for VASPs governed by the laws of a third country (ie non-EEA jurisdictions) to carry out virtual assets exchange services or custodian wallet services in Belgium; and
- VASPs with an establishment or electronic infrastructure in Belgium must register with the Belgian competent authority, the Financial Services and Markets Authority (FSMA).

This client alert discusses the recently introduced ban on non-EEA VASPs and Belgian registration requirements for VASPs.

BAN ON THIRD-COUNTRY VASPS

The Act of 1 February 2022 amending the AML Act to introduce provisions related to the status and supervision of providers of exchange services between virtual and fiat currencies and custodian wallet providers[5] (VASP Act) introduces a prohibition for natural persons and legal entities domiciled in or governed by the laws of a non-EEA jurisdiction (third country) to provide, on a professional basis, exchange services between virtual currencies and fiat currencies and custodian wallet services on Belgian territory.

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2 Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (Text with EEA relevance), OJ L 156, 19 June 2018, p. 43.

3 Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC, OJ L 141, 5 June 2015, p. 73, read in conjunction with the laws transposing the directive and related laws and regulations.

4 Law of 18 September 2017 on the prevention of money laundering and terrorist financing to introduce provisions related to the status and supervision of providers of exchange services between virtual and fiat currencies and custodian wallet providers, BS

5 Law of 1 February 2022 amending the Law of 18 September 2017 on the prevention of money laundering and terrorist financing to introduce provisions related to the status and supervision of providers of exchange services between virtual and fiat currencies and custodian wallet providers, BS 11 February 2022.

In practice, the legislator expects third-country VASPs to establish an entity in Belgium or another EEA jurisdiction and to operate via that entity in Belgium.

The prohibition only applies to providers of exchange services when they offer to exchange virtual currencies and fiat currencies (virtual assets-to-fiat or fiat-to-virtual assets) with their own capital. It does not apply to platforms where users of the platform can exchange virtual assets between each other or to exchange services where one virtual asset is exchanged for another. Furthermore, the Act does not cover initial coin offerings (ICOs).

The VASP Act sanctions non-compliance with criminal sanctions (imprisonment from one month to one year and/or a fine of EUR400 to EUR80,000). These criminal sanctions supplement the pre-existing administrative sanctions for non-compliance with AML/CFT obligations (such as fines up to EUR5 million or 10% of the annual turnover, whichever is higher).

REGISTRATION CONDITIONS FOR VASPS

All VASPs with an establishment or electronic infrastructure in Belgium must register with the FSMA.

The Royal Decree of 8 February 2022 on the regulation and supervision of virtual assets services providers[6] (VASP Royal Decree) lays down the rules and conditions for registration with the FSMA, and the conditions for carrying out these activities and the supervision that such service providers are subject to.

Furthermore, the FSMA published FAQ on its website to assist VASPs with the application of the new regulatory framework.[7]

The registration requirement applies to:

- VASPs domiciled in or governed by the laws of Belgium who provide, on the Belgian territory, virtual asset services
- VASPs domiciled in or governed by the laws of another EEA country having a branch or any other form of permanent establishment in Belgium.
- VASPs domiciled in or governed by the laws of another EEA country with electronic infrastructure, in particular ATMs, in Belgium.

As discussed above, the AML Act prohibits any virtual assets exchange service or custodian wallet service by third-country VASPs. They cannot register with the FSMA without setting up a legal entity in the EEA.

It is not relevant whether the VASP carries out the activity as its principal or ancillary activity. Undertakings that are already regulated under other financial services laws remain subject to the registration requirement but benefit from less comprehensive registration conditions.

The VASP Royal Decree introduces detailed requirements that VASPs must meet on a permanent basis.

The key requirements are:

- establishment of a company with a minimum capital of EUR50,000
- central administration in Belgium
- the persons responsible for the effective management are natural persons who meet fit and proper conditions
- suitability of shareholders
- compliance with the AML Act
- organisational requirements
- payment of a financial contribution to the FSMA

TRANSITIONAL REGIME FOR CURRENT VASPs

The VASP Act did not contain any transitional provisions. Therefore, the ban on non-EEA VASPs entered into force ten days after its publication (ie on 21 February 2022).

The VASP Royal Decree enters into force on 1 May 2022. However, the Royal Decree provides for a grandfathering provision. VASPs that are not registered by that date maintain their authorisation, provided that they notify the FSMA before 1 July 2022 and submit a complete application to the FSMA before 1 September 2022.

Coordination with the EU initiatives regarding crypto-assets regulation

It is likely that this new Belgian regulatory framework will be replaced by a legislative initiative at European level. Notably, the Proposal for a Regulation on Markets in Crypto-Assets (the MiCA Proposal) aims at establishing uniform rules for crypto-asset service providers and issuers at the European level.

7 Royal Decree of 8 February 2022 on the regulation and supervision of providers of exchange services between virtual currencies and fiat currencies and custodian wallet providers, BS 23 February 2022.

8 FSMA, Virtual Asset Service Provider (VASP), https://www.fsma.be/nl/virtual-asset-service-provider-vasp.

As there may be an overlap between the new Belgian regulatory framework and the expected harmonisation of these rules on the European level, service providers must monitor closely how the regulatory framework evolves over time.

Furthermore, the AML Package published by the European Commission in July 2021 will bring further changes in terms of information required when providing crypto-assets transfers. For more information on this specific proposal, please refer to our previous client alert related to the AML/CFT Package.

Conclusion

Belgium has not waited for the European legislator to establish a robust framework of financial supervision on VASPs. The introduction of this regulatory framework requires immediate action from providers of exchange services between virtual currencies and fiat currencies and custodian wallet providers. If these service providers wish to continue providing their services on Belgian territory, they must, at least, notify the FSMA before 1 July 2022 and submit a complete application file with the FSMA before 1 September 2022.

EU

Reverse Solicitation – ESMA's response to request for support in relation to the report on reverse solicitation

On the 3rd January 2022, the European Securities and Markets Authority (ESMA) published a letter (ESMA Letter) dated 17 December, 2021 to the European Commission (Commission) setting out the results of its survey of national competent authorities (NCAs) in connection with the Commission's forthcoming report on the use of reverse solicitation by asset managers and the impact on passporting activities (Report).

The use of reverse solicitation has been subject to increased regulatory scrutiny and commentary by ESMA, the Commission and NCAs over recent years and its use has been further restricted by the introduction of the Cross-Border Distribution framework last year (see our previous publication for further information).

Background

Article 18 of the Regulation on the cross-border distribution of collective investment undertakings ((EU) 2019/1156) (Regulation) requires the Commission to prepare and submit, following a consultation with NCAs, ESMA and other relevant stakeholders, the Report to the European Parliament and to the European Council on reverse solicitation and demand on the own initiative of an investor, specifying the extent of that form of subscription to funds, its geographical distribution, including in third countries, and its impact on the passporting regime.

To the purpose of preparing the Report, in September 2021, the Commission requested ESMA to assist in gathering information from NCAs on the use of reverse solicitation by asset managers and the impact on passporting activities.

Following the request for support, ESMA conducted a survey of NCAs and issued the ESMA Letter.

Survey Results and Proposals

In the ESMA Letter, ESMA sets out the results of the completed survey:

- Identified that under European Union (EU) law asset managers are not subject to any obligation to report to their NCAs any information on subscriptions stemming from reverse solicitation, although some EU jurisdictions may impose local reporting requirements. For this reason, ESMA noted that the vast majority of NCAs had no readily available information to provide on the use of reverse solicitation either via asset managers or investor associations as compared to marketing.
- For those EU jurisdictions (namely, Italy and Cyprus) which did provide statistical information to ESMA, it was clear that the use of reverse solicitation was significant in size. The Italian Supervisory Authority, Consob, reported that, in 2020, 25% of the total subscriptions in funds gathered by Italian asset managers (excluding the amount distributed through third-party distributors) were made on the basis of reverse solicitation. It was noted that in 99% of the cases, subscriptions were for the account of professional investors and frequently related to the establishment of tailor made alternative investment funds. Furthermore, the Cypriot regulator, CySEC, reported that 30% of UCITS management companies and 50% of AIFMs established in Cyprus use reverse solicitation.
- Reported that a number of NCAs believe that "***reverse solicitation is used in practice to circumvent the rules of the third-country and EU passport regimes, which raises some concerns in terms of investor protection but may also create an unlevel playing field between EU asset managers and non-EU asset managers operating in the Union via reverse solicitation.***"

Furthermore, ESMA identified the following steps that could be taken by the Commission to source and collate additional information on the use of reverse solicitation:

- To engage directly with market participants such as asset managers, depositories or account holders, possibly via national and European trade associations.
- To consider the introduction of new reporting requirements to permit the collection of information on the use of reverse solicitation across EU member states.

ESAs publish report on digital finance

On 7 February 2022, the European Supervisory Authorities (ESAs) – which consist of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) – published a joint report in response to the European Commission's February 2021 Call for Advice on Digital Finance (Report).

The Report sets out the ESAs' proposals to ensure the EU's regulatory and supervisory framework remains fit-for-purpose in the digital age. The proposals aim to address key risks arising from the transformation of value chains, the growth of digital platforms and the emergence of new 'mixed-activity groups' i.e. groups which combine financial and non-financial activities.

In summary, the Report sets out the following recommendations:

- adopting a holistic approach to the regulation and supervision of fragmented value chains;
- strengthening consumer protection in a digital context, including through enhanced disclosures, complaints handling mechanisms, mitigating measures to prevent mis-selling of tied/bundled products, and improved digital and financial literacy. This includes reviewing the Distance Marketing of Consumer Financial Services Directive to ensure that disclosures requirements in EU law are fit for the digital age;
- ensuring more consistency across member states in the classification of cross-border services in a digital context;
- addressing Anti-Money Laundering / Counter Terrorism Financing (AML/CFT) risks in a digital context (with particular focus on outsourcing), including assessing as a matter of priority whether all crowdfunding platforms should be brought within scope of the EU AML/CFT framework;
- ensuring effective regulation and supervision of mixed activity groups, including managing relevant prudential risks. In this respect the ESAs suggest updates to and the potential expansion of consolidation rules to ensure effective coverage;
- promoting cooperation and information-sharing between financial and other relevant authorities, such as cyber, consumer protection and competition authorities, including on a cross-border and multi-disciplinary basis; and
- actively monitoring of the use of social media in financial services to address phenomena such as 'social trading' and investment advice shared over social media.

EBA final Guidelines on the limited network exclusion under PSD2

On 24 February 2022 the European Banking Authority (EBA) published its final Guidelines on the limited network exclusion under the second Payment Service Directive (PSD2). The Guidelines clarify the parameters for determining whether a network of service providers or a range of goods and services qualify as 'limited' and, therefore, fall out of scope of PSD2.

Article 3(k) of PSD2 provides that the "Directive does not apply to services based on specific payment instruments that can be used only in a limited way, that meet specified conditions."

This is known as the Limited Network Exclusion (**LNE**). Payment service providers who wish to make use of this exclusion and who undertake activities, for which the total value of payment transactions executed over the preceding 12 months exceeds the amount of EUR 1 million, must notify national competent authorities accordingly.

According to the EBA, there are significant inconsistencies on how national competent authorities have been applying the LNE across the EU, thereby undermining the level playing field in the Union.

The Guidelines set out the provisions, and where relevant, criteria and indicators, to ensure that payment instruments that can benefit from the LNE are used in a limited way. Examples of payment instruments that might fall within this exclusion, according to the EBA, include store cards, fuel cards, public transport cards, and meal vouchers.

Importantly, the Guidelines clarify that the functional connection between goods and services should be based on a specific category of goods and services with a common purpose, rather than a leading good or service. This marks a departure from what was originally proposed during the consultation phase.

The Guidelines will come into effect on 1 June 2022. There will also be a three-month transitional period for issuers that already benefit from the LNE to allow them to submit a new notification to their national competent authority.

US

US Treasury signals helpful limitations on "broker" definition under new cryptocurrency reporting rules

The US Treasury Department recently sent a letter to six senators signalling a limitation on the definition of a "broker" to potentially exclude stakers, miners, and software providers in the blockchain and cryptocurrency space.

As previously discussed in our November issue, legislation adopted via the Infrastructure Investment and Jobs Act (HR 3684) included language meant to increase reporting obligations and tax collections from facilitators of digital asset transactions by greatly expanding the definition of a broker to include "any person who (for consideration) is responsible for providing any service effectuating transfers of digital assets on behalf of another person." This expansive definition would have likely caused virtual currency miners, software developers, stakers, and other entities who do not actually facilitate transactions to be subject to the broker reporting rules.

While the law was passed, opponents of the law signalled that there may be further changes to ring-fence the law to only include exchanges through which consumers buy, sell, and trade digital assets.

On February 11, Treasury Assistant Secretary for Legislative Affairs Jonathan Davidson sent a letter[8] to a group of six senators – Cynthia Lummis (R-WY), Mark R. Warner (D-VA), Rob Portman (R-OH), Kyrsten Sinema (D-AZ), Pat Toomey (R-PA) and Mike Crapo R-ID)[9] – stating that "the department's view is that ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers." This language seems to suggest that, contrary to the original guidance, "ancillary parties" such as miners, stakers, and software developers will likely not be subject to the broker reporting rules. The letter also stated that Treasury intends to issue proposed regulations further clarifying the broker definition for these purposes.

While this letter is far from formal guidance and will likely see further refinement, including "the extent to which other parties in the digital asset market, such as centralized exchanges and those often described as decentralized exchanges and peer-to-peer exchanges, should be treated as brokers," it provides some relief to industry leaders and taxpayers who may have been inadvertently been subject to the broker rules.

8 While a full copy of the letter could not be obtained, certain quotations from the letter were obtained here: Treasury Signals Crypto Miners Won't Face IRS Reporting Rule (1) (bloomberglaw.com).
9 See https://www.theblockcrypto.com/post/134039/us-treasury-reiterates-that-the-irs-wont-consider-crypto-miners-stakers-or-coders-to-be-brokers.

Managing climate risk

The Office of the Comptroller of the Currency (OCC) is seeking stakeholder feedback on draft principles intended to help guide US banks with more than USD100 billion in total consolidated assets in identifying and managing climate-related financial risks.

While the OCC guidance, announced December 16 2021, is aimed at larger banks, it also will likely influence many small and regional banks in developing strategies to address risks associated with a changing climate. Indeed, an OCC Bulletin issued in conjunction with the draft principles includes a note to community banks that "all banks, regardless of size, may have material exposures to climate-related financial risks."

OCC's high-level framework does not mandate new regulations but is part of broader scrutiny among financial regulators in the US and globally to encourage banks to be more focused on and transparent about the risks from climate change to properties they finance and their exposure to fossil fuel investments.

The general principles call for banks' boards of directors and management to demonstrate an appropriate understanding of climate-related financial risk exposures, allocate necessary resources, assign climate-related financial risk responsibilities throughout the organization and maintain clear internal lines of communication.

Climate-related financial risk exposures should be considered when setting the bank's overall business strategy, risk appetite and financial, capital and operational plans, and management should develop and implement climate-related scenario analysis frameworks. Risk mitigation plans should particularly focus on credit, liquidity, operations, legal issues and compliance, and other financial and non-financial risks.

International

FSB Commonwealth of Independent States group discusses risks relating to high debt levels and crypto assets

On the 25 November 2021, the Financial Stability Board (FSB) Regional Consultative Group (RCG) for the Commonwealth of Independent States (CIS) met to discuss key risks relating to high debt levels and crypto assets.

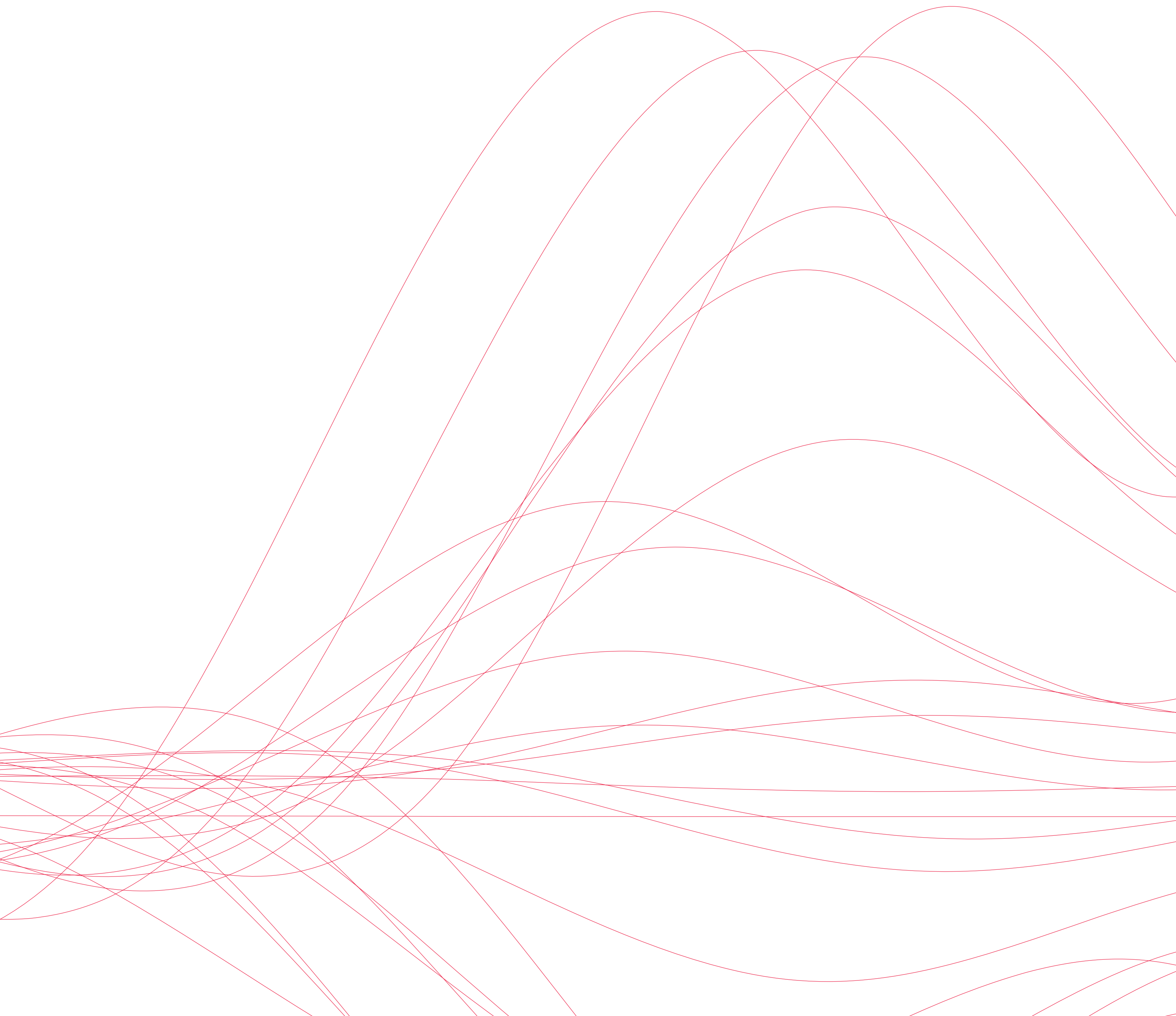
Membership of the RCG CIS comprises financial authorities from Armenia, Belarus, Kazakhstan, Kyrgyz Republic, Russia and Tajikistan. The current co-chairs are the Deputy Finance Minister of the Russian Federation, and the Deputy Governor for the Central Bank of Armenia.

The FSB coordinates the implementation of international and national standard setting amongst national financial authorities, developing and promoting the implementation of effective financial and regulatory policies to foster stable financial markets.

During the meeting, members discussed vulnerabilities in the global financial system that are of particular relevance to CIS economies and Emerging Market and Developing Economies (EMDEs) more generally. Topics covered included:

- Long-term financial risks resulting from COVID-19, in particular, corporate and household over-indebtedness and possible policy responses.
- Procyclicality in the financial system and policy implications for EMDEs.
- Developments in crypto-asset markets, including their impact on financial systems and financial stability in EMDEs. This is particularly relevant given the recent acceleration in the use of digital assets during the COVID-19 pandemic. Stablecoins have seen a significant uptick in use, specifically as a means of payment. Moreover, the upcoming advent of Central Bank Digital Currencies (CBDCs) may have significant impacts on payment markets and on credit efficiency in financial systems.
- Risks to financial stability relating to the entry of retail investors into CIS capital markets. Retail investors may also be vulnerable to speculation in crypto-assets, as these typically have no or very limited investor protections.
- Progress to date and next steps for the G20 roadmap to enhance cross-border payments.
- Promoting the development of financial education and the implementation of strategies to improve financial literacy in CIS countries.

Looking ahead, the group received an update on the FSB's work programme for 2022, to be discussed at a later stage.



SWIFT and the Ukraine conflict: Latest developments

This article was accurate at time of publication on 28th March 2022. For updates on this piece please visit our website.

On 26 February 2022, the EU, UK, Canada and the US published a Joint Statement on further restrictive measures in light of the Ukraine conflict. These nations committed to ensuring selected Russian banks are removed from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system.

Seven Russian Banks were banned from SWIFT on 12 March 2022.

Three Belarusian entities will be banned from SWIFT on 20 March 2022.

SWIFT is a Belgian-based financial messaging services cooperative supporting 11,000 banking and securities organisations, market infrastructures and corporate customers in more than 200 countries. As a result of the ban, these selected Russian banks will be unable to initiate payment instructions in eligible payment systems or receive inbound payments in those same systems.

Banned Russian banks and Belarusian entities may seek alternatives to SWIFT, such as routing payments via countries that have not imposed sanctions, such as China, which has its own payments system called the Cross-Border Interbank Payment System (CIPS). Russia has a SWIFT alternative known as the System for Transfer of Financial Messages (SPFS) which may also be used as may cryptoasset payments platforms.

Alternatives to SWIFT have critical interoperability, cost, security and speed constraints.

Banned Russian Banks

On 2 March 2022, the EU published European Council Regulation (EU) 2022/345 and European Council Decision (CFSP) 2022/346 in the official journal of the European Union. This Regulation and Decision identified the selected Russian banks that are subject to the SWIFT ban.

These banks are: VTB Bank (being Russia's second largest bank), Vnesheconombank (VEB), Rossiya Bank, Sovcombank, Bank Otkritie, Novikombank and Promsvyazbank.

The ban took effect on 12 March 2022.

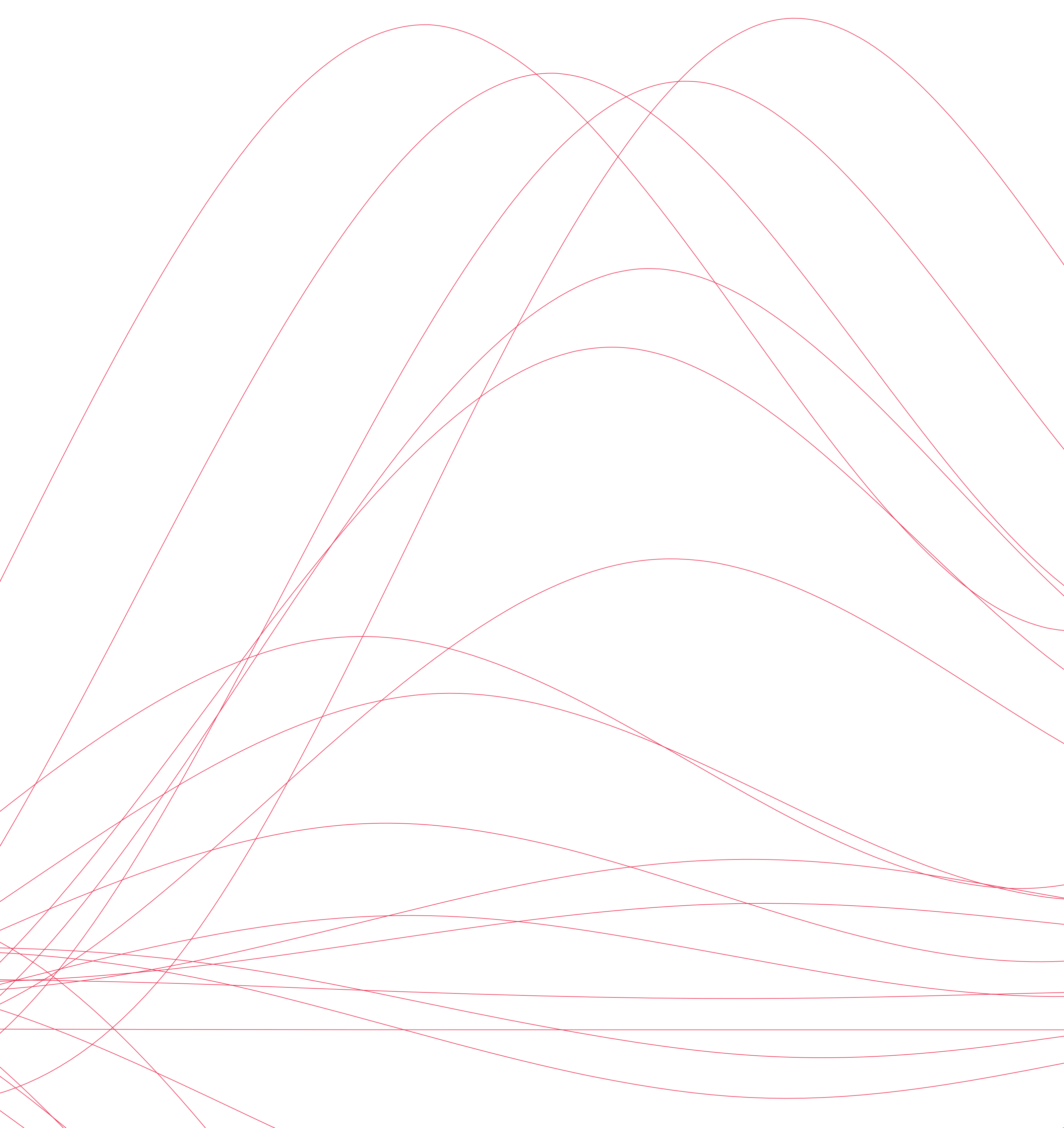
The official journal also applies the measure to "any legal person, entity or body, established in Russia whose proprietary rights are directly or indirectly owned for more than 50%" by these Russian banks.

This list does not include Sberbank, Russia's biggest lender by assets, or Gazprombank, which is heavily involved in its energy sector. According to the EU press release, the European Commission "is prepared to add further Russian banks [to the list] at short notice."

Alexei Kudrin, Russia's former finance minister, suggested all Russian financial institutions being cut off from SWIFT could shrink Russia's economy by 5%.

Banned Belarusian Entities

On 12 March 2022, SWIFT published a statement noting that it had disconnected the selected Russian banks and will also disconnect the following three Belarusian entities (and their designated Belarus-based subsidiaries) on 20 March 2022 in accordance with a further Regulation, being Council Regulation (EU) 2022/398: Belagroprombank, Bank Dabrabyt and the Development Bank of the Republic of Belarus.



What is SWIFT?

SWIFT acts as the carrier of messages containing payment instructions between financial institutions involved a transaction.

The SWIFT organisation itself does not manage accounts for institutions, holds no institution funds and does not perform clearing or settlement functions. After a payment has been initiated using a SWIFT message, it must be settled through a payment system such as the Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET2).

SWIFT sends more than 40 million messages a day, 1% of which involve Russian payments.

SWIFT is jointly owned by 2,000 banks and financial institutions. SWIFT's board of directors comprises 25 independent directors appointed by its shareholders. According to Article 17 of the SWIFT By-laws, nations with more member institutions of SWIFT have additional rights to appoint directors.

SWIFT is overseen by the National Bank of Belgium, in partnership with major central banks around the world, including the US Federal Reserve and the Bank of England.

On 1 March 2022, SWIFT published a press release noting the Joint Statement and stating that SWIFT is engaging with these authorities to understand which entities will be subject to these new measures. SWIFT states that it will disconnect them when it has received a legal instruction to do so.

How are members removed from SWIFT?

Article 16(c) of the SWIFT By-laws state that:

"c. The Board of Directors may suspend or expel a Shareholder from the Company if it establishes in its opinion that such Shareholder:

– does not observe the By-laws of the Company and/or the Corporate Rules or any undertaking towards the Company;
– makes any arrangement or composition with or concerning its creditors;
– is subject to regulations impacting its shareholding in the Company;
– commits an act of negligence which may be prejudicial to the interest of the Company provided that the Board of Directors informs the Shareholder in writing of the reasons underlying its decision and that the relevant mandatory provisions under Belgian law are complied with."

Part 3 of the SWIFT Corporate Rules also provides that the board of directors should be provided a written report from SWIFT management for the termination of an existing shareholder. Termination (expulsion) is subject to section 7.3 on dispute resolution in the SWIFT Corporate Rules.

SWIFT has not published the minutes of the meeting of its board of directors in which the decision to ban the selected Russian banks was made in accordance with the Regulation (EU) 2022/345 and Counsel Decision (CFSP) 2022/346. The SWIFT board of directors will also expel the three Belarusian entities relying on the further European Council Regulation (EU) 2022/398.

All relations between SWIFT and each member, as well as the SWIFT by-laws and SWIFT Corporate Rules, are governed by the laws of Belgium.

On 14 March 2022, the Financial Times reported that various bankers and financial regulators (not named) are concerned about the prospect of a cyberattack (or attacks) against SWIFT. SWIFT provided a statement to the Financial Times noting that it takes "security very seriously" and has "a strong control environment in place for physical and cyber security."

Alternatives to SWIFT

SPFS

As part of the Crimea-related sanctions of 2014, Russia was threatened with expulsion from SWIFT. Western countries did not proceed with this action, but this did prompt Russia to begin the development of its own cross-border transfer system, SPFS.

At the end of 2020, there are 23 foreign banks connected to the SPFS from Armenia, Belarus, Germany, Kazakhstan, Kyrgyzstan and Switzerland. There are also plans to link SPFS to payment systems in China, India and Iran. These plans may be accelerated to the extent that a significant number of Russian banks are banned from SWIFT.

SPFS is not seen as a viable alternative to SWIFT, given that the system currently works only within Russia and is subject to high transaction costs.

Bank-to-bank connections

Russian banks may choose to deal directly with non-Russian banks to process payments using traditional payments channels such as fax, email, and any available bilateral messaging systems. This would likely add delays and additional costs to the payments process which may be passed on to the payer/payee.

It may also lead to payments business transferring to non-sanctioned Russian banks that are not subject to the SWIFT ban.

Cross-Border Interbank Payment System

The CIPS is a payment system offering clearing and settlement services for its participants in cross-border RMB payments. It is a significant payment infrastructure in China.

In advocating for Russia not to be banned from SWIFT, Austrian Chancellor Karl Nehammer said "the suspension of SWIFT would affect the Russian Federation less than the European Union," and argued Russia could use its "own payment system, and secondly, it would immediately switch to Chinese payment systems."

The identity of participants is not in the public domain. But according to the CIPS Participants Announcement No 73, in January 2022 CIPS has 75 direct participants and 1205 indirect participants. Russian banks likely will be both direct and indirect participants of CIPS.

Cryptoasset payment networks

Banning Russian banks from SWIFT may result in Russian payment being processed in decentralised networks such as bitcoin.

According to Banco Santander, Russia's import/export flows total around USD570 billion annually, a volume that could be accommodated on the bitcoin network. Bitcoin processes USD20 billion in on-chain transactions per day, or more than USD7 trillion per year.

Impact of the ban

For counterparties to contractual relations, the removal of Russian institutions and the forthcoming removal of the Belarusian entities from SWIFT due to European Commission Decisions may provide grounds for recission due to illegality.

DLA Piper expects that counterparties may seek to rely on illegality, including as an event of default, in a variety of commercial and financial arrangements.

There remains considerable uncertainty as to the status of in-flight transactions at the time that SWIFT access is banned. These payments will be subject to their respective payment systems' contingency, liquidity management and resolution mechanisms.

The impact of the SWIFT ban has been largely overshadowed to date by the sanctioning of Russian persons and firms; and the actions of some card schemes and corporates to cease operating in Russia. Russian banks not subject to the SWIFT ban, such as Sberbank, are facing significant liquidity challenges as deposits are withdrawn and liabilities are drawn down. Sberbank closed its European legal entities in compliance with an order by the European Central Bank as a result of EU sanctions.

The Bank of Russia has lowered reserve requirements for Russian banks and continued to increase interest rates to over 20%, given the liquidity gap in the Russian banking system, which is reported to be USD68 billion. On the day of the announcement of the SWIFT ban, Russian citizens withdrew close to a trillion Roubles, which represented 6.5% o the monetary base.

The SWIFT ban, as well as sanctions and other corporate actions, could contribute to a default on Russian obligations abroad. This may result in a liquidity shock to Western markets, given that Russian entities owe more than USD100 billion in the next financial year, according to IMF estimates. Both Russian banks' and Russian government instruments have been subject to credit rating agency downgrades, with Fitch Ratings stating it expects the SWIFT ban to be extended to other Russian banks.

Holders of Russian bonds who were due to receive interest payments totalling USD117 million on 16 March 2022 said on 17 March that they have not yet seen any funds - despite the Russian Finance Minister claiming the payment had been made through a correspondent bank. The 30 day "grace period" within which those late interest payments must be made before a non-payment default occurs under the bonds has now started ticking. If payment is not made, this would be the first Russian Government default on its foreign currency debt since the Russian Revolution in 1917.

According to Kristalina Georgieva of the IMF, a Russian government default is no longer an improbable event but she has discounted the idea of a wider shock to the global financial system should this default occur.

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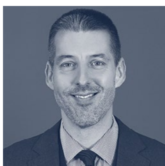

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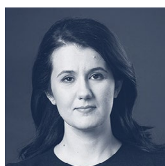

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