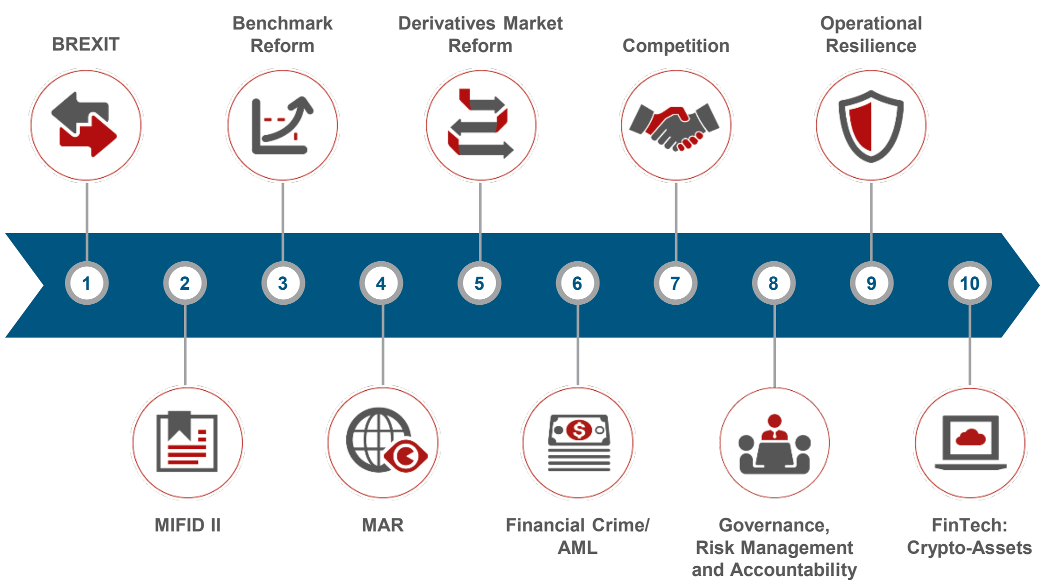
10 KEY REGULATORY FOCUS AREAS FOR UK/EUROPEAN WHOLESALE MARKETS IN 2019

As we approach the end of the post-crisis regulatory reform agenda, we are still witnessing fast-paced regulatory developments that are undeniably and significantly driven by Brexit — with no signs of things slowing down in 2019. In this publication, we highlight what we are seeing as the top regulatory focus areas for our clients during the year ahead, focusing on wholesale market structures and conduct risk.

These topics are attracting particular attention because they are either at a key stage in the regulatory change or implementation cycle, or because uncertainty and inconsistency in their recent implementation means that they are drawing industry and supervisory focus and require industry harmonisation. We also include emerging trends that are attracting a great deal of political and regulatory supervisory attention.

We hope that this list serves as a useful cross-check against your regulatory focus areas for the first, second, and third lines of defence.



1 BREXIT

Key dates

- 15 January 2019: UK Parliament to vote on the Brexit deal
- Q1 2019: HM Treasury, PRA, FCA, and Bank of England to finalise plans for onshoring EU financial services legislation
- 29 March 2019: UK to leave the EU (assuming no extension)
- 30 March 2019 – 31 December 2020: Potential transitional period (if Brexit deal is agreed)

Planning for a no-deal Brexit

Naturally Brexit has been, and will continue to be, a top priority for firms. It remains the case that firms have little choice but to continue to plan for the scenario under which the UK will leave the EU at 11 p.m. on 29 March 2019 with no deal and no (politically agreed) transitional period. HM Treasury and the UK regulators have been planning for this outcome for some time, and firms should take comfort in the regulators' preparedness. The temporary permissions regime for inbound EEA firms, and the regulators' powers to grant transitional relief, should prove particularly helpful in this respect. Although the UK measures to mitigate any cliff-edge effects of Brexit largely are not being reciprocated by the EU, there are helpful plans afoot to recognise UK CCPs on a temporary basis, and to allow counterparties to novate derivatives contracts to EU entities without triggering clearing obligations under EMIR.

Planning for transition under the Brexit deal

In the event that the Brexit Withdrawal Agreement is ratified, there will be a transitional period until the end of 2020 at least. This will give firms more time to implement their Brexit plans, and to monitor any political developments. The UK and the EU will start negotiating in earnest on the future relationship, developing the Political Declaration that was published in November 2018. The principles outlined in the Declaration suggest that, in relation to financial services, both sides will aim for "close and structured cooperation on regulatory and supervisory matters", including seeking to conclude equivalence assessments by July 2020.

Assessing interdependencies

Regardless of whether there is a hard or soft Brexit, firms will need to spend much of 2019 carefully analysing and documenting the flows and dependencies between their UK and EU27 vehicles. They will need to ensure that outsourcing arrangements are properly identified, documented, and have adequate oversight, and that differences in approach to regulatory requirements, or arising through the UK's onshoring process, are identified and addressed.

New frontiers

In a speech in early December 2018, John Glen, the Economic Secretary to the Treasury, indicated that the UK government was actively considering a post-Brexit international financial services strategy that would bring "together the full international toolbox with the aim of solidifying London's position as the deepest, most liquid, and most globally connected wholesale market". We have already seen the US-UK Financial Regulatory Working Group established, and it will be interesting to see what this and other related third-country bilateral developments bring for firms that intend to keep the UK as their dominant, ex-US, global service centre.

2 MIFID II

Key dates

- 3 January 2019: Annual aggregated costs and charges disclosures begin
- Q1 2019: ESMA expected to provide feedback on its call for evidence on periodic auctions for equity instruments
- 1 March 2019: Mandatory SI regime for derivatives, securitised derivatives, ETCs, ETNs, SFPs and emission allowances will come into effect
- First half of 2019: FCA expected to share findings from its thematic review of research pricing

Market structures

We will see the continued evolution in 2019 of market structure and trading behaviours consequent on MiFID II changes. The mandatory SI regime for derivatives, securitised derivatives, ETCs, ETNs, SFPs, and emission allowances will come into force. There will also be a continued focus on firms' control environment around algorithmic trading, following the additional guidance issued by the FCA and PRA at the beginning of 2018.

Inducements and research unbundling

This is a complex area, and the first under MiFID II to have attracted FCA thematic work. The FCA announced in June 2018 that it would be reviewing firms' implementation of the MiFID II rules on research and corporate access, with a particular focus on pricing models. The FCA has since been reviewing activities on both the buy-side and the sell-side.

Meanwhile, the rules on research have already changed the research market, both in the EU and globally. While the US SEC's "no action" letter still has some time to run before the temporary relief expires, there is already a shift towards paying for research separately.

Firms must also retain an awareness of the wider inducements rules, and continue to assess all non-execution-related benefits and services in the context of the restrictions.

Costs and charges

The implementation of the costs and charges regime in wholesale markets has been fraught with compliance challenges, resulting in discrepancies between different firms' approaches to disclosure. We expect to see more work to try to standardise disclosures during 2019, following the first round of annual aggregated disclosures.

Product governance

The MiFID II product governance regime goes far beyond the FCA's pre-existing rules on product governance, and firms have grappled with the breadth of its reach. This has led to firms needing to take a view as to what is proportionate and appropriate in a given context. Many in the industry have tried to create a harmonised approach by using standard templates and standard form disclosures. We expect the FCA to focus post-implementation work on how firms have defined target markets.

Transaction reporting

This is a key area for the FCA, and one of the most heavily enforced areas under MiFID I. In July 2018, Mark Steward, FCA Director of Enforcement and Market Oversight, discussed how the increased volume and detail of the transaction reports that the FCA is receiving under MiFID II is enhancing its ability to detect both cross-product and cross-market abusive trading. He confirmed that the FCA has "invested heavily in our technical capacity to ingest, process and use all this information. We are processing 30 million transaction reports per day and we have planned for a 20% increase in capacity and processing of data over 5 years, although there is no upper limit on the ingestion or processing of this information". Bearing this in mind, we can expect to see continued supervisory and enforcement action in this area, with the FCA keen to make an example of firms falling short of the expected standards. In this regard, we draw your attention to the slides from the FCA's Transaction Reporting Forum held in June and July 2018, and Market Watch 55, which contain important guidance to firms on addressing common failings that the FCA is seeing in reports.

3 BENCHMARK REFORM

Key dates

- 2019 (ongoing): Work continues to develop alternative risk-free rates to replace LIBOR
- 1 January 2020: End of the transitional period under the EU Benchmarks Regulation (subject to possible extension)
- End 2021: FCA will cease requiring banks to contribute to LIBOR

LIBOR transition

Market participants know that LIBOR's days are numbered, but at present many obstacles remain to the transition away from LIBOR. Through a Dear CEO letter issued in September 2018, the regulators have urged firms to make sure they are doing enough to prepare, and have sought assurance that designated senior managers are taking charge of firms' planning. We expect the regulators to offer feedback in early 2019 on the state of firms' readiness for transition, identifying areas of transition planning that require particular focus and attention.

However, a key challenge firms face is that there is no LIBOR replacement rate as yet. Work is underway in LIBOR currency jurisdictions to develop alternative risk-free rates, while legacy transactions that reference LIBOR remain a key issue for the industry.

EU Benchmarks Regulation implementation

With the transitional period expiring on 1 January 2020, there will be a focus during 2019 on benchmark administrators becoming authorised or recognised. There is pressure from the industry for the transitional period to be extended by two years in order to avoid market disruption. Primarily this request relates to critical benchmarks, which may not be compliant in time for 2020. However, the request also extends to other benchmarks, in particular benchmarks administered by third-country entities.

There has not been the anticipated take-up for third country benchmark administrators ensuring access to their benchmarks in the EU, and there is no transparency regarding which administrators are likely to get authorised in time. Consequently, there are concerns that EU users and markets could face severe disruption if third-country benchmarks suddenly cannot be used in the EU from 2020.

4 MAR

Key dates

- Q1 2019: FCA expected to publish an "Approach to Market Integrity" document
- 2019 (ongoing): Following Market Watch 58, FCA to "continue to work closely with market participants to ensure a consistent, effective implementation of MAR"

Extra-territorial impact on capital markets deals

MAR's extra-territorial reach means that market participants are conducting MAR-compliant market soundings on various non-EU deals. The advent of ESMA's FIRDS database means that it is relatively straightforward to check whether an issuer has any EU-listed financial instruments (including involuntary listings), providing the relevant EU nexus for MAR to apply. As MAR continues to bed in, we expect to see MAR-related issues dealt with more routinely in the context of non-EU deals.

Trade surveillance / record-keeping / STORs

The FCA has in the past emphasised that compliance with MAR is a "state of mind". This requires understanding and agility, rather than a tick-box approach. Through its Market Watch publications in 2018, the FCA has also flagged up the discrepancy of market coverage by firms' surveillance and reporting mechanisms, noting that many firms still focus most of their attention on equity markets rather than fixed income. As with transaction reporting, STORs are a crucial source of intelligence for the FCA, and failings in this area are likely to attract serious penalties.

Further, global regulatory co-operation on data sharing could well feed into future enforcement action. With billions of transaction reports being shared between authorities, it would not be surprising if this data were to lead to at least one significant enforcement case. The FCA also plans to clarify its expectations regarding conduct in wholesale markets by publishing a new paper in its Approach Document series — "Approach to Market Integrity".

5 DERIVATIVES MARKET REFORM

Key dates

- Q1 2019: European Commission expected to adopt legislative proposals amending EMIR
- 9 May 2019: Clearing obligation under EMIR will take effect for category 4 counterparties in respect of certain credit default swaps
- 21 June 2019: Clearing obligation under EMIR will take effect for category 3 counterparties
- 9 August 2019: Clearing obligation under EMIR will take effect for category 4 counterparties in respect of certain interest rate derivatives
- 1 September 2019: Initial margin requirements apply to Phase 4 entities

Margin rules

Phasing in of the initial margin rules, and the clearing obligation, will continue during 2019. Provisions forming part of the EMIR REFIT package are expected to provide welcome relief for certain counterparties when they come into force. Until that happens, market participants will continue to rely on regulatory forbearance in the relevant areas.

CCP location

The European legislators are now close to finalising their amendments to EMIR that will introduce the controversial CCP location policy. This policy will allow the European Commission to determine that some third-country CCPs are of such systemic importance that they can provide services in the EU only if they are located in the EU. The UK has been opposed to this measure, which has taken on heightened significance in the context of Brexit.

6 FINANCIAL CRIME / AML

Key dates

- Q1 2019: HM Treasury to consult on gold-plating MLD5
- By 31 March 2019: House of Lords Select Committee to report on its review of the Bribery Act 2010
- Q2 2019: FCA expected to publish a Discussion Paper on the role and responsibility of the financial services sector and consumers in tackling fraud
- First half of 2019: FCA expected to publish findings from thematic review of harm caused by money laundering in capital markets

Opaque structures

We expect to see increased attention in this area in light of recent scandals, and the suggestion in Europe that regulators have not been doing enough. Opaque ultimate beneficial ownership structures have come under closer scrutiny, and are likely to continue to attract attention. Although the UK received a generally positive review of its AML and CTF regimes from the FATF, there are some areas likely to see change. One of these is the SARs regime, under which UK intelligence receives a plethora of information with limited intelligence value. The Law Commission has already started consulting on how to reform this regime, so firms may expect to see change in 2019.

FinTech

Particular financial crime concerns have been raised in relation to crypto-assets. See section 10 below.

7 COMPETITION

Key dates

- Q1 2019: FCA to publish the final report in its investment platforms market study
- First half of 2019: FCA due to publish a Policy Statement on further remedies under the asset management market study

CMA investigation

The Competition and Markets Authority announced an investigation in November into "suspected anti-competitive arrangements" in the financial services sector. Although details of the investigation have not been announced, it is understood to concern activities in the bond markets. Given the general increased focus on competition in financial services, it was only a matter of time before a significant investigation emerged. If substantiated concerns do emerge, this investigation could be a real watershed moment for the industry.

General

The FCA continues to step up its competition capabilities, and is focused on competition law aspects in much of its work. Conscious that its concurrent competition powers were granted on a "use it or lose it" basis, we should expect to see the FCA making more prominent use of its powers.

8 GOVERNANCE, RISK MANAGEMENT, AND ACCOUNTABILITY

Key dates

- Q1 2019: FCA expected to publish final rules relating to the proposed new Directory of individuals working in financial services firms
- Pre-9 December 2019: FCA expected to finalise its position regarding the head of legal and the scope of the client dealing function
- 9 December 2019: Extended SMCR to come into force for all FCA solo-regulated firms

SMCR implementation and enforcement

The Senior Managers and Certification Regime (SMCR) continues to bed in for banks and insurers, whilst other firms are focusing on implementation plans for the extended regime, which will come into effect on 9 December 2019. Firms should not wait to begin their preparations, as a number of aspects of the regime will take time to assess and implement. Although the industry saw the first much-publicised enforcement action under the regime last year, many firms and senior managers will feel that the first real "scalp" is yet to come. There is still a feeling that more guidance is needed about what is expected of senior managers, and enforcement cases will help to illustrate where the regulators draw the line. Meanwhile, the regulators continue to iron out issues with the regime — for example, the FCA is still considering the status of the head of legal, and plans to consult on clarifying the scope of the client dealing function under the Certification Regime.

Culture, conduct, and diversity

Although these topics have been high on the regulatory agenda for some time now, 2018 saw the FCA really focus in on them and introduce some new rhetoric that firms need to take on board. From the FCA's Discussion Paper on transforming culture in financial services, to public correspondence with the government and speeches making plain that the FCA views non-financial misconduct (such as sexual harassment) just the same as "traditional" misconduct, there has not been a shortage of opportunities for the message to be relayed.

The FCA has also emphasised that diversity can no longer be seen as a "nice to have", and that diversity is now a core part of how the regulator assesses culture within a firm. We can expect a continued focus on these topics in 2019.

Whistleblowing

Whistleblowing arrangements are an important cultural indicator. The regulators are keen to ensure that individuals feel able to speak out, and that firms deal with whistleblowing situations appropriately. The recent FCA feedback given to banks about their whistleblowing arrangements highlighted that, although whistleblowing is being taken seriously, firms could do more to increase training and awareness, and to prevent the victimisation of whistleblowers.

9 OPERATIONAL RESILIENCE

Key dates

- 30 June 2019: Expected date from which new EBA Guidelines on outsourcing will apply
- First half of 2019: Feedback expected on the PRA, FCA, and Bank of England Discussion Paper on building the UK financial sector's operational resilience

Cyberattacks: Data / asset security

Cyber resilience is seen as so important to the regulators that it came second only to Brexit in the FCA's Business Plan for 2018/19. The FCA has put out a stream of publications on the topic, including the recent report from a cross-sector survey of firms' cyber and technology resilience. The FCA, PRA, and Bank of England also published a joint Discussion Paper on firms' operational resilience. The first fine for cyber-related failings should serve as a lesson to the industry going forward — in this instance the right processes largely were in place, they just did not operate as intended when facing a real live situation.

Business continuity

IT failures and outsourcing risks are some of the biggest threats to the industry. With many firms trying to move away from legacy systems and update infrastructure to meet new regulatory demands, change management processes and procedures are absolutely key. The recently launched Treasury Committee inquiry into IT failures in the financial services sector may well lead to more enforcement action in this area. Meanwhile, scrutiny of critical outsourcing arrangements is set to increase, particularly as new third-party technology services come to market.

10 FINTECH: CRYPTO-ASSETS

Key dates

- Q1 2019: FCA to consult on proposed perimeter guidance regarding crypto-assets, and HM Treasury to consult on whether the regulatory perimeter should be extended to crypto-assets with comparable features to specified investments
- Q1 2019: FCA to consult on restricting the sale of derivatives referencing crypto-assets to retail clients

Regulatory treatment

As the current regulatory framework was not designed with crypto-assets in mind, regulators have been struggling to classify them and work out how they do (and should) fit into the existing structure. Regulators around the globe have taken different approaches, but the UK regulators have been biding their time so far. However, this is set to change following the UK Cryptoassets Taskforce's final report. The report announced that the FCA will consult on additional perimeter guidance specific to crypto-assets, and HM Treasury will consult on potential changes to the regulatory perimeter to bring crypto-assets that have comparable features to existing regulated investments within the scope of regulation, and explore how cryptocurrencies like Bitcoin might be regulated if necessary. These consultations will be welcomed by established financial services institutions, as they have the potential to remove regulatory uncertainty and will help take a step toward legitimising crypto-assets as a new asset class for trading.

Consumer protection

The FCA is concerned about consumer protection in relation to crypto-assets, and has distributed consumer warnings (as have other global regulators) to inform consumers about the potential volatility of such assets. This approach is set to continue, with the FCA planning to consult on a potential ban on the sale of derivatives referencing cryptocurrencies like Bitcoin to retail customers.

Financial crime

Another key concern in relation to crypto-assets is their anonymity and therefore the risk that they might be used for financial crime. The FCA sent a Dear CEO letter to firms in June 2018 to warn about these risks and advise them of the precautions they should put in place. At European level, cryptocurrencies are being brought within the scope of the AML framework. In the UK, HM Treasury plans to go even further by gold-plating these rules, extending AML obligations to more peripheral operators such as exchange services between different crypto-assets and platforms that facilitate peer-to-peer exchange of crypto-assets. HM Treasury also plans to consult on extending UK obligations to firms based outside the UK when providing services to UK consumers.

Contacts

David Berman
Partner
T +44.20.7710.3080
E david.berman@lw.com

Carl Fernandes
Partner
T +44.20.7710.4777
E carl.fernandes@lw.com

Nicola Higgs
Partner
T +44.20.7710.1154
E nicola.higgs@lw.com

Jon Holland
Partner
T +44.20.7710.4766
E jon.holland@lw.com

Andrea Monks
Partner
T +44.20.7710.4767
E andrea.monks@lw.com

Rob Moulton
Partner
T +44.20.7710.4523
E rob.moulton@lw.com

Kishore Bhindi
Associate
T +44.20.7710.4785
E kishore.bhindi@lw.com

Brett Carr
Associate
T +44.20.7710.4695
E brett.carr@lw.com

Charlotte Collins
Knowledge Management
T +44.20.7710.1804
E charlotte.collins@lw.com

Stuart Davis
Associate
T +44.20.7710.1821
E stuart.davis@lw.com

Gabriel Lakeman
Associate
T +44.20.7710.4645
E gabriel.lakeman@lw.com

Anne Mainwaring
Associate
T +44.20.7710.1018
E anne.mainwaring@lw.com

Sam Maxson
Associate
T +44.20.7710.1823
E sam.maxson@lw.com

Ella McGinn
Associate
T +44.20.7710.4649
E ella.mcginn@lw.com

Frida Montenius
Associate
T +44.20.7710.1161
E frida.montenius@lw.com

Denisa Odendaal
Associate
T +44.20.7710.1845
E denisa.odendaal@lw.com

Jonathan Ritson-Candler
Associate
T +44.20.7710.1815
E jonathan.ritson-candler@lw.com

Emily Torrens
Associate
T +44.20.7710.1883
E emily.torrens@lw.com