March 2020

PRIVATE BANK BRIEFING

Issues Impacting the Private Bank Sector

Welcome to our quarterly round-up of legal and compliance issues impacting private banks and their clients.

In This Edition

COVID-19: FCA Sets Out Its Expectations of Firms' Responses

On 17 March 2020, the FCA published a new webpage providing information on its expectations of firms' response to the coronavirus. It will update the webpage over the coming weeks and expects to adapt its guidance accordingly. Private banks are therefore advised to check the webpage regularly for updates.

Key messages from the FCA are that it expects all firms to:

- Take reasonable steps to ensure that they are adequately prepared to meet the challenges to both their business and their customers as a result of the coronavirus, particularly through their business continuity plans
- Provide strong support and service to customers
- Actively manage their financial resilience and liquidity, reporting to the FCA immediately if they believe they will be in difficulty

The FCA's primary goals are to ensure customers are protected and that markets continue to function well.

The FCA is also reviewing its current work plans such that it can postpone regulatory change activity which is not critical to protecting consumers and preserving market integrity during this time.

Market Trading and Reporting

The FCA is cognisant that firms are moving to alternative sites and engaging in widespread working-from-home arrangements, and reminds firms to be aware of the systems and controls challenges that could arise in these circumstances. For example:

- Firms should continue to record calls and electronic communications that are within scope of the rules, irrespective of the fact that staff may not be in their typical office. Where they are unable to do so, firms should take steps to mitigate the associated risks (*e.g.*, enhanced monitoring and/or retrospective review).
- Where firms experience difficulties in submitting their regulatory data (*e.g.*, pre- and post-trade transparency reports and transaction reports), the FCA expects them to maintain appropriate records and submit the data as soon as possible. Firms are reminded that this does not permit them to unnecessarily delay these submissions. If firms do anticipate difficulty in meeting their ongoing reporting obligations, they must contact the FCA as soon as possible to discuss their arrangements.
- Firms should continue to take all steps to prevent market abuse risks. The FCA will continue to actively monitor for market abuse (and take enforcement action where necessary).

Firms should mitigate the impact on consumers

Firms should take initiatives that go beyond their usual business practices to support customers, noting that the FCA considers its rules as already providing that flexibility to firms. Examples include waiving fees associated with accessing Individual Savings Accounts (ISAs) or deposit accounts and granting customers flexibility in relation to their mortgage payments. Where firms do implement such strategies, they should notify the relevant regulator.

The FCA expects firms to continue to handle customer complaints promptly and within the prescribed timeframes. Where this is not possible, firms should write to customers explaining why they have not met the deadline.

The FCA has also provided specific examples of best practice:

- Access to cash: Firms should take measures, such as increasing daily cash withdrawal limits, to enable customers to have sufficient access to cash.
- Unsecured debt products: The FCA wants firms to show greater flexibility to customers in persistent credit card debt. For example, FCA rules require that where a customer makes minimum repayments for 36 months, the debt provider must offer the customer options to repay the debt more quickly. If the customer does not respond to this outreach, the debt provider must suspend the customer's card. For customers currently in this situation, debt providers are to give customers until 1 October 2020 to respond to their communications before suspending their cards.

Delays to forthcoming FCA publications and extended period to provide feedback to open consultations

The FCA is also reviewing its current work plans such that it can postpone regulatory change activity which is not critical to protecting consumers and preserving market integrity during this time. As a result, the FCA will continue with a small number of planned regulatory change initiatives which will protect vulnerable consumers or otherwise where major long-term programmes would be disrupted. Otherwise, the FCA has extended the closure dates for feedback for its published Consultation Papers and Calls for Input, listed at the end of its webpage, until 1 October 2020.

COVID-19: Bank of England Announces Measures to Address Challenges Faced by Firms

The Bank of England and the Prudential Regulation Authority (PRA) have announced a number of measures aimed at alleviating operational burdens on PRA-regulated firms, and Bank-regulated financial market infrastructures (FMIs), in the wake of the COVID-19 outbreak. These measures are intended to provide flexibility to help firms and FMIs focus on maintaining their safety and soundness and delivering the critical functions they provide to the economy.

Key measures that the Bank and the PRA are taking include:

Changes to the supervisory approach

In order to allow supervisory engagement to focus on the most important matters relating to financial stability, the safety and soundness of firms, and protection of policyholders, the PRA will modify its usual supervisory approach.

Bank and PRA supervisors will review their work plans so that non-critical data requests, on-site visits, and deadlines can be postponed, where appropriate. This includes pausing the Section 166 reviews relating to the reliability of banks' regulatory returns that were announced in October 2019.

The PRA will also review its approach to considering and processing Senior Management Function applications, with a view to reducing the burden involved during current events.

These measures are intended to provide flexibility to help firms and FMIs focus on maintaining their safety and soundness and delivering the critical functions they provide to the economy.

Postponement of policy work

The PRA plans to postpone non-critical work for the time being. Immediate changes include:

- Postponement of the joint Bank/FCA survey into open-ended funds.
- Extending the deadlines for responses to the current consultations on "Building Operational Resilience: Impact tolerances for important business services" and "Outsourcing and third party risk management" to 1 October 2020, in line with the FCA's approach.
- Implementation of changes to the credit risk modelling framework for banks using the internal ratings based approach will be delayed by one year to 1 January 2022. The move to hybrid internal ratings based models will also be delayed until 1 January 2022. Firms using the standardised approach to credit risk will benefit from a delay to changes they need to make relating to the definition of default.
- The PRA will be coordinating internationally to ensure that UK implementation of Basel 3.1 will happen alongside other major jurisdictions, given that the existing implementation timetable may now prove challenging.

The PRA will keep the regulatory change agenda under review to determine which further elements may need to be postponed. It also plans to bring forward the first meeting of its Financial Services Regulatory Initiatives Forum, which was established to help regulators identify and manage peaks in operational demands on firms and FMIs resulting from regulatory initiatives, and to ensure that firms and FMIs have an early and clear understanding of the regulatory change agenda. Following that meeting, the PRA intends to publish a Regulatory Initiative Grid to ensure that a coordinated future work plan is available for firms to consult as early as possible in light of COVID-19.

Cancellation of stress testing

The Bank has decided to cancel the 2020 stress test for the eight major UK banks and building societies, to help lenders focus on meeting the needs of UK households and businesses via the continuing provision of credit. The Financial Policy Committee and the Prudential Regulation Committee expect that all elements of banks' capital and liquidity buffers can be drawn down as necessary to support the economy through this shock.

Approach to accounting standards

The PRA reminds firms that it can consider whether their provisioning under applicable accounting standards is flowing through into their regulatory capital position in an appropriate way. The PRA therefore emphasises that forward-looking information used to incorporate the impact of COVID-19 on borrowers into the expected credit loss estimate needs to be both reasonable and supportable for the purposes of IFRS 9. In the event that firms believe such forecasts can be made, the PRA expects firms to reflect the temporary nature of the shock, and fully take into account the significant economic support measures already announced by global fiscal and monetary authorities.

The Bank states that it expects to provide further guidance to firms regarding its approach shortly, with a view to assisting firms to adopt consistent approaches.

Brexit: Current State of Play

Following the entry into force of the Withdrawal Agreement on 1 February 2020, which established the terms of the UK's orderly withdrawal from the EU, the UK has entered into a transitional arrangement until 31 December 2020. During this period, EU law continues to apply, and UK firms continue to benefit from EU rights such as passporting arrangements.

During this transitional period the UK and the EU will need to negotiate and agree the terms of their future relationship — failure to reach an agreement by the end of the transitional period would result in the UK exiting the EU on a no-deal basis unless the UK government requested (and the EU agreed to) an extension to the transitional arrangement. The deadline for the UK government to request an extension to the transitional arrangement is 1 July 2020. However, the government has written into law that the transitional period may not be extended, effectively ruling this option out — although the government could reverse this prohibition by passing an amendment to the Withdrawal Agreement Act.

Accordingly, the prospect of a no-deal exit remains as if neither an extension nor a trade deal is agreed, the transitional arrangement will end, and the UK will trade with the EU as a third country on World Trade Organization (WTO) terms — effectively a no-deal exit for financial services given the limited WTO treatment. In light of this potential outcome, the FCA has made clear that it expects firms to consider how the end of the transitional period might affect them and their customers, and the action they may need to take ahead of 1 January 2021. In particular, this involves assessing and planning for the implementation of the UK Brexit onshoring legislation, which preserves the vast majority of existing EU legislation that does not already form part of the UK statute book by onshoring this into UK law. In order to avoid a cliff-edge scenario, not all of these onshored requirements will take effect on exit day. Rather, the PRA and the FCA have been given temporary transitional powers, meaning they can phase in these requirements over time to allow flexibility for firms to transition to a fully domestic regulatory framework.

Consequently, a key focus for private banks will be assessing the onshored obligations relevant to them and mapping the implementation timeline for each of these obligations. In particular, firms should be aware that the relevant onshoring statutory instruments do not set out all of the transitional provisions applicable to each piece of legislation, as there are separate statutory instruments that deal with the transitional positions. Therefore, these instruments need to be viewed as a whole to understand the relevant transitional timelines.

Sustainable Finance: EU Agenda for 2020

Financial services regulators have been particularly vocal in the last 12 months, specifically about the impact on the financial services sector as the world experiences, and attempts to respond to, climate change. Initiatives seeking to promote ESG values have been launched at the global, EU, and UK levels. ESG is an umbrella term for a broad range of environmental, social, and governance factors, against which investors can assess the behaviour of the entities and/or products they are considering for investment. (See Sustainable Finance and Climate Change Risk in Financial Services.)

As sustainable finance gains momentum, private banks should consider how they will transition to apply the new rules and requirements.

ESG's rise in importance is directly linked to financial institutions' increased awareness of the risks to investments associated with ESG issues, and regulators have made clear that they expect financial services firms to play a key role in leading the way on the path to change. The EU is well advanced with its plans to transition to a green economy. The key EU measures centre around the European Commission's Sustainable Finance Action Plan, which was first published in March 2018, and aims to ensure that the EU financial sector is at the forefront of establishing a green economy.

The Sustainable Finance Action Plan forms a constituent part of the EU's broader Green Deal, which formally launched in December 2019. As part of this, the Commission plans to start preparing another set of green finance initiatives, scheduled for publication in autumn 2020.

Key EU sustainable finance measures of interest to private banks include:

The taxonomy

The Sustainable Finance Action Plan includes the creation of a unified EU classification system (a taxonomy) for determining whether an economic activity or investment qualifies as environmentally sustainable. This measure will establish consistent criteria for labelling a product as green, which will be applied by financial market participants marketing sustainability-themed funds, and by Member States setting out national rules on labelling investment products. The taxonomy is crucial to the initiative, as without a common standard for what is classed as green, the labelling of products will not be consistent, readily understood, or reliable.

Disclosure

The Disclosure Regulation is being introduced to improve disclosure of how institutional investors and asset managers integrate ESG factors into their decision-making processes. Institutional investors and asset managers will also have to show how their investments correlate to their ESG targets, and explain how they comply with these. This will ensure that the buy-side are more transparent about the way in which they invest. The Disclosure Regulation is designed to encourage uniformity by establishing a consistent set of rules on how financial market participants inform investors of the integration of ESG risks and opportunities, which will address the inconsistent reporting of ESG issues to date.

MiFID II reform

There are planned amendments to the MiFID II Delegated Acts (and the Insurance Distribution Directive) to help distributors of investment products to ensure that products and, when relevant, the related services, are offered in the interest of clients, and that sustainability factors are taken into account in the target market assessment.

ESMA has sensibly suggested a fairly flexible and pragmatic approach to integrating ESG considerations into the product governance regime. Whilst it is recognised that it is difficult to substantively move the agenda forward in this regard before a common EU taxonomy for articulating sustainability is in place, ESMA has provided technical advice making recommended changes to MiFID II.

Key points to note in relation to the changes proposed by ESMA are as follows:

- The amendments would not mean that investment products need always have a reference in their target market to whether or not the product fulfils ESG preferences. This should help assuage concerns among firms that the changes could require them to place ESG preferences above other considerations, and could therefore potentially lead to misselling risks.
- The intention is not to give an impression that the identification of ESG preferences in the target market should be considered more relevant than clients' investment objectives and other characteristics. Investment objectives and ESG preferences are separate points, and should remain so to avoid misselling, which may happen should ESG preferences take precedence over a client's personal investment objectives.
- Distributors will also need to be mindful of ESG target market disclosures provided by manufacturers in defining their own target market. ESMA is of the view that, in line with this requirement, distributors should not recommend or market products for which they are unable to at least check the plausibility of certain product features — especially if they are used for marketing purposes. Usually, the clients to whom such products are targeted have even less information available to verify whether or not a product fulfils ESG preferences, and therefore rely on the distributors to perform this role.

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Benchmarks

Legislation amending the EU Benchmarks Regulation to introduce a new category of low-carbon benchmarks came into force on 10 December 2019. This new market standard will help investors effectively allocate their assets into sustainable portfolios. The amendments to the EU Benchmarks Regulation are a response to the perceived lack of uniformity among existing low-carbon indices. The new measures will introduce a new category of low-carbon benchmarks, and an obligation for all benchmarks (with the exception of those related to interest rates and foreign exchange) to disclose in their benchmark statement whether or not they pursue ESG objectives, and whether or not the benchmark administrator offers such ESG-focused benchmarks.

As sustainable finance gains momentum, private banks should consider how they will transition to apply the new rules and requirements. Regulators in the UK and Europe are taking green finance increasingly seriously and will want to see that firms have credible plans in place to help with progress towards achieving ESG and climate-related goals.

LIBOR: Preparations for Transition

The Bank of England, the FCA, and the Sterling RFR Working Group published a suite of documents (which can be found on the Bank of England's dedicated LIBOR webpage) on 16 January 2020, outlining priorities, expectations, and milestones for 2020 on LIBOR transition. These documents are an important read for all firms grappling with LIBOR transition.

The Working Group's priorities and roadmap for 2020 give a timeline of the Working Group's top 2020 priorities, including:

- Cease issuance of GBP LIBOR-based cash products maturing beyond 2021 by the end of Q3 2020
- Take steps throughout 2020 to promote and enable the widespread use of SONIA compounded in arrears
- Take steps to enable a further shift of volumes from GBP LIBOR to SONIA in derivative markets
- Establish a clear framework to manage the transition of legacy LIBOR products, to significantly reduce the stock of GBP LIBOR referencing contracts by Q1 2021
- Provide market input on issues around "tough legacy" contracts

The publications also include a helpful fact sheet for end-users, summarising LIBOR transition and setting out why market participants need to act now, which may be useful for private banks to provide to their customers.

In addition, as part of this publication, the Sterling RFR Working Group's Term Rate Use Case Task Force published a working paper on the development and use of a forward-looking, term-based SONIA. Although a term SONIA rate does not currently exist, administrators are working on the development of an IOSCO-compliant rate, which is expected be published in early 2020 for a period of observation so that market participants can understand the nature and behaviour of the rates before they are used in actual financial products.

However, the Sterling RFR Working Group's prevailing view is that backward-looking, daily compounded SONIA should be the norm, and future use of a term SONIA should be limited to certain specified circumstances, and in particular to what are referred to as "tough legacy contracts" (*e.g.*, in mortgage contracts, in contrast to the current use of GBP LIBOR).

Additionally, the PRA and the FCA have published a series of speeches setting out their expectations regarding the transition away from LIBOR. They have also sent letters to senior management at larger financial institutions and asset managers to explain what progress the regulators expect to see, and to make clear that firms should operate on the basis that LIBOR will not be available after the end of 2021. When reviewing these items, private banks should also bear in mind the guidance published by the FCA in November 2019 regarding conduct risk and LIBOR.

The Bank of England and the FCA sent a letter on LIBOR discontinuation to UK trade associations representing non-financial businesses explaining how LIBOR discontinuance may affect their members and stakeholders, in order to try to raise general awareness of the possible implications of LIBOR transition.

The letter asks the trade associations to help raise awareness among their networks and gives advice on doing so. This effort underlines the general importance of LIBOR, and the fact that its discontinuance has implications that extend beyond the financial services sector. This may be particularly acute in the private bank sector, where private bank clients are more likely to have some direct LIBOR exposure.

The key messages from all of these documents for private banks include:

- 2020 is the key year for firms to engage with LIBOR transition, and doing nothing is not an option
- Firms should urgently identify their own and their clients' exposure to LIBOR, if they have not done so already
- Plans should be put in place to address LIBOR exposure that extends beyond the end of 2021
- Firms should consider how to communicate to customers decisions around LIBOR transition and how they will ensure fair treatment
- Firms should cease issuing and/or entering into contracts and products for both themselves and their clients that reference LIBOR and continue beyond the end of 2021
- There should be a senior employee within firms with responsibility for LIBOR transition
- Firms should be aware of the risk of regulatory action if they fail to act on LIBOR transition

Private banks should also note that the FCA has stated, in light of COVID-19, that the central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet.

Product Intervention: ESMA Technical Advice on the Effects of MiFID II Product Intervention Measures

On 3 February 2020, ESMA published a Final Report advising the European Commission on the effects of the product intervention powers given to ESMA under MiFID. ESMA has the power to temporarily prohibit or restrict the marketing, distribution, or sale of certain financial instruments, and so far ESMA has used this power in relation to two financial instruments: binary options and contracts for differences (CFDs). ESMA's measures for binary options expired on 1 July 2019, and its measures for CFDs expired on 31 July 2019. Those measures have been replaced by permanent national restrictions.

The Final Report states that, following the temporary prohibition on the sale of binary options, there were no new authorisations of firms offering binary options to retail clients, and in general, there is no longer an authorised binary options market for retail clients in the EU. The Final Report also states that there has been an overall decrease in the number of CFD retail client accounts, though there has been an increase in the number of clients treated as professional clients on request.

The Final Report recommends that ESMA be given the power to make permanent product intervention measures, or in the alternative, to make available the option to extend its intervention powers for a further 18 months. Currently, ESMA has the power to make interventions for only up to three months at a time, with an option to extend its measures for a further three months on a rolling basis. ESMA is concerned that the current short timeframe in which it can make interventions before it is required to review the intervention further and decide whether or not to renew is insufficient to tackle a significant investor protection concern. In addition, ESMA believes that potential divergence from its measures by national regulators following the expiry of a measure prevents a level playing field across Europe. Consequently, this is an area in which there could be change as part of the wider review of the MiFID II framework.

MiFID II: European Commission Consults on MiFID Refit

On 17 February 2020, the European Commission launched a public consultation on its review of the MiFID II framework. This consultation is complementary to ESMA's more specific and technical consultations, and will inform the Commission's reports to the Parliament and the Council, which could ultimately lead to legislative change. The consultation was scheduled to run until 20 April 2020, although this is likely to be extended.

Of particular interest to private banks, priority areas for review under the consultation include various investor protection topics and the research regime. The Commission is using the paper to consider well-known areas of MiFID that have attracted criticism and debate, and also open up discussions about how MiFID II might need to be modernised. For example, the Commission considers how some of the MiFID II provisions need to be updated to accommodate the EU's Digital Finance and Sustainable Finance workstreams.

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Investor protection

The consultation picks up on the December 2019 European Council conclusions on the deepening of the Capital Markets Union, which invited the Commission to consider introducing new categories of clients, improving direct access to simple financial instruments (e.g., plain vanilla bonds, index ETFs, and UCITS funds) when proportionate and justified, and ensuring adequate investor protection for retail clients in relation to complex products. The Commission is now seeking to understand the challenges that different categories of investors are confronted with when purchasing financial instruments in the EU, in order to evaluate where adjustments would be needed.

The Commission is exploring which requirements might be amended to facilitate direct access to simple financial instruments, focusing on product governance, costs and charges requirements, and conduct requirements. This includes considering whether the product governance regime is inhibiting access to products and could be applied in a more proportionate way, particularly to non-complex and non-retail focused products. The Commission is also exploring whether enhanced investor protection measures are needed in the case of complex products sold to retail clients.

Ex-ante cost disclosures

The Commission is exploring the usefulness of the ex-ante cost disclosures in the case of professional and ECP clients. The Commission notes that a "wide range of stakeholders" consider these disclosures to be a mere administrative burden, given that they are aware of the current market and pricing conditions. The Commission is therefore consulting on whether clients could opt out unilaterally from ex-ante cost information obligations and whether there should be conditions attached to this.

Sustainability transition

The Commission is revisiting its rules requiring the provision of information in a "durable medium", based on its Green Deal and Sustainable Finance agenda and the fact that access to financial markets is typically via online tools. The Commission is seeking views on the phase-out of paper-based information and feedback on how this could be implemented (e.g., a general phase-out over a 5-10 year period and/or explicit opt-outs for retail clients).

EU-wide database of investment products

The Commission is seeking feedback on the introduction of an EU-wide database for investment products to address a perceived desire from retail investors to compare product information (namely costs) in a transparent way. In this context, the Commission is seeking views on which products it should prioritise for inclusion in an EU-wide database (*e.g.*, all transferable securities, PRIIPs, and/or UCITS).

Client categorisation

The Commission is considering the introduction of a new client category of "semi-professional", which would capture high net worth or sophisticated investor types. The rationale is that this may make it easier for those categories of retail investors to participate in the capital markets, which could involve a tailor-made investor protection regime for these clients.

The Commission is also consulting on lowering the quantitative threshold for a professional client's investment portfolio from €500,000, which may be an alternative to creating a new regime for semi-professional investors.

The creation of a new (fourth) category of client is likely to create interest among private banks and online investment firms, but it is difficult to see how much of an advance this will be unless the application of rules such as costs and charges and product governance to professional investors is also addressed.

Product governance

The Commission is consulting on a number of proposals to simplify the MiFID II product governance regime, including restricting the scope of the regime to carve out high denomination products and products that are only eligible for distribution to qualified investors, and expressly permitting distribution of products to retail clients in the negative target market on the basis of express client instructions. The Commission is also considering limiting the application of the regime to complex products only. These proposals have the potential to de-scope certain non-retail and non-complex products from the regime.

Investment advice

Akin to the UK's regime that came into force under the Retail Distribution Review, the Commission is consulting on an outright ban on inducements paid to independent investment advisers, since feedback from consumer associations indicates that the inducements regime is not sufficiently dissuasive to prevent conflicts of interest in the distribution process.

The Commission is also considering a new, potentially exam-based, certification requirement for staff providing investment advice, to address the issues resulting from diversified national educational and professional systems.

Distance communications

The Commission picks up on the practicalities of sending clients ex-ante costs and charges information prior to executing an order that is placed over the phone, which delays the immediate execution of the order. The Commission highlights that this, together with the telephone recording requirements, has led to some banks ceasing telephone-based services altogether. The Commission is therefore considering a rule change to allow the provision of costs and charges information after the execution of a transaction in the case of distance communications (via telephone, in particular).

Best execution

The Commission is seeking market feedback on the quality of best execution reports to assess whether the provision of information (*e.g.*, on top five trading venues) is useful to investors. There has been significant criticism from the industry about the (lack of) benefit this information provides.

Research

The Commission is particularly focused on an apparent consequential decline in research coverage of small- and medium-size enterprises (SMEs), which it states have suffered a reduction in coverage with potential knock-on impact on liquidity and the number of European IPOs. Accordingly, the Commission is consulting on a number of ways to overhaul the MiFID regime as it applies to SMEs, including:

- Carving out SME research providers and independent research providers from the unbundling rules
- Introducing rules to prevent under-pricing and ensure research is paid for on a reasonable commercial basis
- Amending the rules on free trial periods
- Encouraging public or market operator financing of SME research production
- Considering the use of artificial intelligence to assist in generation of SME research
- Creating an EU database of publicly available SME research, potentially developed by ESMA
- Liberalising the rules on issuer-sponsored research

If adopted, these proposals would represent a substantial relaxation of the regime as it applies to SME research. Interestingly, many of these proposals pick up on those published by the French regulator, the Autorité des Marchés Financiers (the AMF), in January of this year, which also presented a number of substantial amendments and relaxations to the regime targeted at supporting the French research industry. The MiFID II research regime was heavily influenced by the FCA, and so the Commission's proposals represent continued increasing potential for divergence in this area in the wake of Brexit.

PRIIPs: European Commission Report on PRIIPs KID Consumer Testing Exercise

On 27 February 2020, the European Commission published a Final Report on retail investors' preferred option regarding performance scenarios and past performance information within the Key Information Document (KID) under the PRIIPs framework.

As part of the consultation on amendments to the PRIIPs KID, the European Supervisory Authorities (ESAs) and the Commission carried out a consumer testing exercise to consider whether changes to the content and format of the performance scenarios are necessary. They also considered how, and the extent to which, including information on past performance in the KID can be relevant for retail investors when making investment decisions. The ESAs previously stated that they intend to conclude their review by the end of Q1 2020, with a view to submitting their proposals to the European Commission shortly afterwards.

The testing exercise comprised an online consumer test, with 7,684 participants across five countries, using different versions of the KID. These different versions included future performance scenarios, past performance information, and illustrative scenarios. The exercise gathered evidence on how retail investors interpret the figures presented to them, and the most appropriate ways to communicate the limitations of, or assumptions underlying, these figures.

The report concludes that, overall, the test results suggest that a consumer's final investment decision is not affected by the version of the KID, but the design of the KID can play an important role in aiding consumers' understanding

The report contains the following key findings:

- Only a small section of the consumers tested seemed to understand the probabilistic information on the likelihood of different scenarios. However, the inclusion of this information increased the percentage of correct answers to relevant questions on product identification. Therefore, it may be beneficial to incorporate features from the probabilistic approach, but it may be advisable to consider alternative ways of framing this information.
- The application of the past performance version of the KID, which also included probabilistic information, improved the accuracy of answers in the consumer test. Further, participants seemed to understand that future performance cannot be accurately predicted by past performance information. However, the impact of past performance was not tested independently of the probabilistic information, making it difficult to determine the true impact of this information. Although there was evidence that the inclusion of simple past performance information has no negative effect, the addition of more complex past performance information may have negative implications on consumers' comprehension.
- The testing provided no significant evidence to support the inclusion of illustrative scenarios. Despite some improvements in consumers' understanding of product features when using the illustrative scenario version of the KID, these improvements could reasonably be attributed to the probabilistic information also included in this version of the KID.
- The report concludes that, overall, the test results suggest that a consumer's final investment decision is not affected by the version of the KID, but the design of the KID can play an important role in aiding consumers' understanding of the features of the retail investment products and in contributing to better informed financial decision-making. It will be important to monitor how these findings play into the ESAs' final proposals to the Commission.

Asset Protection: Government Consults on Expanding Dormant Assets Scheme

On 21 February 2020, HM Treasury and the Department for Digital, Culture, Media & Sport launched a joint consultation on expanding the dormant assets scheme under the Dormant Bank and Building Society Accounts Act 2008. The current scheme enables participating banks and building societies to channel funds voluntarily from dormant accounts (cash accounts with at least 15 years of customer inactivity) towards good causes through an authorised reclaim fund (ARF). The consultation notes that this scheme is narrower than other international schemes, which typically cover a wider range of assets.

The government has therefore been considering how best to bring a wider range of financial assets into the scheme. In the consultation, the government proposes that the scheme could be extended to cover insurance, investment and wealth management, and securities products. Although industry stakeholders recommended the inclusion of certain pensions products, the government does not think that these assets should be included in the scheme at this time.

The consultation proposes that the expanded scheme would operate on the same basis, and with the same underlying principles, as the current scheme. For example, firms' first priority before transferring assets into the scheme would be to trace and reunite people with their assets, and asset owners would be able, at any point, to reclaim the amount that would have been due to them had a transfer into the scheme not occurred.

The government's proposals are summarised in the table below. Responses to the consultation are requested by 16 April 2020.

Asset Class	Definition	Definition of Dormancy	Reclaim Value
Dormant bank and building society account balances (already included in the scheme)	The balance of accounts held with the bank or building society that have at all times consisted only of money	No transactions have been carried out in relation to the account by or on the instructions of the holder of the account for 15 years (and introduce a new requirement that, in that period, the firm has made reasonable efforts to contact the owner, which have been unsuccessful)	The value of the dormant account, including any accrued interest and adjusted for any fees owed
Dormant insurance policy proceeds Proceeds of life insurance policies with a contractual end date: • Savings endowments • Term insurance Proceeds of life insurance policies without a contractual end date: • Whole-of-life assurance • Investment bonds	Proceeds of savings endowments, term insurance, whole-of-life assurance and investment bonds, provided they: • Are a "contract of insurance", as defined in Schedule 1 of the FSMA (Regulated Activities) Order 2001; and • Crystallise to cash by operation of a contractual, legal, or regulatory event	*With a contractual end date* If there is a death claim, whichever comes earlier: • The point at which it is identified that a deceased customer has no next of kin; or • Seven years after a death claim is accepted and there is no ongoing contact with those managing the estate; and, in that period, the participant has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful If there is no death claim: • Seven years after the end of the term; and • In that period, the firm has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful *Without a contractual end date* Same as for a contract with a contractual end date, where there is a death claim.	The value of the insurance policy proceeds at the point of crystallisation, plus any accrued interest

Asset Class	Definition	Definition of Dormancy	Reclaim Value
Dormant share proceeds Proceeds of shares in PLCs and/or open-ended investment companies (OEICs)	Proceeds of shares, as defined in section 540 of the Companies Act 2006, provided they are in: • UK-registered PLCs, as defined in section 4 of the Companies Act; and/or • OEICs, as defined in section 237(3) of FSMA	No transactions have been carried out or contact made in relation to the asset by or on the instructions of the asset owner for 12 years and: • In that period, the firm has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful; and • Where applicable, three distributions or other sums to which the person is or was entitled remain unclaimed or unpaid	In line with participating companies' share forfeiture terms
Dormant unit proceeds Proceeds of units in an authorised unit trust (AUT)	Proceeds of units in an AUT scheme, as defined in section 237 of FSMA		The value of the units at the time the owner makes their reclaim and it is verified, plus any distributions paid since the assets were liquidated and transferred to an ARF
Dormant investment asset distributions and proceeds Distributions and proceeds of investment assets: • Distributions; • Redemption proceeds; • Balances from inactive cash accounts; and • Orphan monies received after a fund is wound up	Distributions and proceeds of investment assets, defined as products of a collective investment scheme other than an AUT, as defined in section 235 of FSMA, including: • Distributions of income; • Redemption proceeds; • Balances from inactive cash accounts; and • Orphan monies received after a fund is wound up	No transactions have been carried out or contact made in relation to the asset by or on the instructions of the asset owner for six years and: • In that period, the participant has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful; and • Where applicable, three distributions or other sums to which the person is or was entitled remain unclaimed or unpaid	The value of: • Fund distributions; • Redemption proceeds; • Inactive cash accounts; and/or • Orphan monies at the time they were due
Other dormant security distributions Dividends and proceeds from corporate actions	Dividends, as defined in section 829 of the Companies Act, and unclaimed proceeds from corporate actions, including: • Consideration to a company under section 981(6) or held in trust under section 981(9) of the Companies Act (whether before or after the commencement of the Act); or • Consideration a company is liable to pay or transfer to a member or creditor pursuant to an order sanctioning a compromise or arrangement under section 899 of the Companies Act (whether that order was made before or after commencement of the Act)	*Dividends* No transactions have been carried out or contact made in relation to the asset by or on the instructions of the asset owner for twelve years; and, in that period, the firm has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful *Proceeds from corporate actions* 12 years after the date the company received the consideration; and, in that period, the participant has made proportionate and reasonable efforts to reunite the asset with its owner, which have been unsuccessful	The value of: • Dividends; and/or • Proceeds from corporate actions at the time they were due

Governance: FCA Dear CEO Letter on Non-Financial Misconduct

On 6 January 2020, the FCA published a "Dear CEO" letter on non-financial misconduct. Although addressed to CEOs of wholesale general insurance firms, the letter contains messages that are applicable across the financial services sector, and so private banks should take note of the FCA's expectations. The letter indicates that non-financial misconduct is an area of focus for the FCA and sets out the FCA's views as to how firms should improve their culture.

In particular, the FCA believes that how a firm handles non-financial misconduct — including discrimination, harassment, victimisation, and bullying — is indicative of a firm's wider culture. Also indicative is a lack of diversity and inclusion, which the FCA considers obstructs the development of an environment in which good decisions can be made.

In the letter, the FCA has identified the following elements as crucial to improving a firm's culture:

- **Leadership:** The FCA sees leadership as key to addressing non-financial misconduct, and will rely on the SMCR to help improve culture in firms. The FCA reminds firms that in its fitness and propriety assessments of Senior Managers, it will consider factors including capability, honesty, integrity, and reputation, including non-financial misconduct. When a Senior Manager fails to take reasonable steps to address non-financial misconduct, the FCA may determine that they are not "fit and proper". This is the first time that the FCA has drawn an explicit link between a firm's response to non-financial misconduct and the fitness and propriety of the individual responsible for the area in which the misconduct occurred (even if that individual did not personally engage in any misconduct).
- **Purpose:** The FCA encourages firms to reflect on any inconsistencies between their espoused purpose and strategy and the reality of their business practice, people management and formal governance, systems, and controls. In particular, the FCA expects firms to have strong whistleblowing processes in place, along with appropriate incentive structures.

The FCA believes that how a firm handles non-financial misconduct — including discrimination, harassment, victimisation, and bullying — is indicative of a firm's wider culture.

Firms are expected to review this Dear CEO letter and share it with the senior executive committee and board. If firms identify any gaps or shortcomings, the FCA expects firms to act promptly to address them. Therefore, private banks should reflect on the messages in this letter and consider what action they might need to take in order to ensure they are meeting the FCA's expectations.

Governance: EBA Benchmarking Report on Diversity Practices Under CRD IV

On 3 February 2020, the European Banking Authority (EBA) published a report on the benchmarking of diversity practices in CRD IV firms, and called for measures to promote more gender balance within firms' management bodies. The EBA is mandated to collect information on firms' diversity policies and benchmark diversity practices under the CRD IV Directive.

The EBA found that, out of the 834 CRD IV firms it collected data from in 2018, almost 42% have not adopted a diversity policy, contrary to the provision under CRD IV that requires firms to do so, and to take into account the diversity of the management body when recruiting new members. The EBA also found that: (i) not all firms that have a diversity policy actually promote gender diversity by setting a target for the number of women in particular positions; (ii) the representation of women in management bodies is still relatively low; and (iii) many institutions do not have a gender-diverse board.

Firms should consider additional measures to promote a more gender-balanced management body, in addition to complying with the requirement to adopt a diversity policy.

According to the EBA's findings, the diversity policies adopted across EU Member States differed significantly, particularly with regard to gender diversity targets. For example, in 2018, at an EU-wide level, 66.95% of firms had no gender diversity amongst their executive directors. The EBA also found evidence of a gender pay gap: in most firms, the remuneration of male members in management was higher than that for female members.

In the EBA's view, firms should consider additional measures to promote a more gender-balanced management body, in addition to complying with the requirement to adopt a diversity policy.

Private banks should bear the EBA's findings in mind when considering whether they are meeting regulatory expectations with regard to diversity. This development is significant in the context of some private banks given recent press on the subject. According to Citywire data, the ratio of female-to-male fund managers hovers around 10%, well below near-parity in equivalent specialist roles in law and accounting, with significantly little progress year on year (Citywire, 5 March 2020).

Culture: FCA Calls on Firms to Develop a Purposeful Culture

On 5 March 2020, the FCA published a Discussion Paper (DP20/1) on driving purposeful cultures. The paper focuses specifically on how having a clearly defined purpose is integral to a healthy culture, and features a foreword by the FCA setting out its views and thoughts, followed by a collection of essays that present a range of perspectives from industry leaders, professional bodies, and culture experts. This is the first time that the FCA has focused on precisely what it expects from firms in relation to developing a meaningful purpose, and the paper presents some helpful and tangible ideas that private banks can integrate into their businesses.

The FCA describes purpose as "what a firm is trying to achieve — the definition of what constitutes success … and the motivation for people to go to work for them". The regulator makes clear that, as with culture overall, it will not dictate or prescribe what a firm's purpose should be. The FCA explains that purpose could relate to a number of things — it might be social, ethical, consumer-driven, or people-driven. It could also be articulated in various ways, for example, through a mission, a vision, or values. Ultimately, the FCA considers that purpose needs to mean something to a firm's employees and resonate throughout the organisation, and the FCA says that "in many sectors and for many years, the stars haven't aligned [which] created unhealthy cultures". Firms need a purpose "beyond just making money".

The FCA is of the view that a strong purpose can attract future talent, help businesses identify and manage risks, and help firms focus on their longer-term goals over short-term pressures. However, a key issue that the FCA has identified in relation to firms' developing their purpose is fear. The FCA explains that firms are often afraid to focus on longer-term goals when faced with the pressure to meet shareholders' expectations and deliver on profits in the short term. They may also be unwilling to be the "first mover" in taking the right steps when competitors are not making the same sort of changes.

This is the first time that the FCA has focused on precisely what it expects from firms in relation to developing a meaningful purpose, and the paper presents some helpful and tangible ideas that private banks can integrate into their businesses.

The FCA stresses the importance of purpose being propounded not only from the top of an organisation, but also from middle management. The FCA expects that firms will need to align decision-making, recruitment, and internal progression with organisational purpose, and for middle management to be empowered to lead teams in acceptance with the firm's values, for purpose to resonate throughout an organisation and really be authentic. The essays in the paper contain a range of ideas that firms can take on board, and the FCA encourages firms to see if they can adopt at least one new idea to help create a more purposeful culture. Private banks should read the paper with interest and consider how they are addressing this key driver of culture. The regulator's focus on culture is set to continue, and so it is crucial that private banks take note of the FCA's developing expectations in this area.

Patient Capital: FCA Amends Permitted Links Rules

On 4 March 2020, the FCA published a Policy Statement (PS20/4), setting out changes to its permitted links rules in COBS 21.3.

The permitted links rules set out categories of assets in which firms may invest to provide linked benefits in unit-linked life policies sold to retail customers. They are designed to ensure that, where a natural person is holding the investment risk, the assets underlying unit-linked life policies are appropriate for retail investors.

The amended rules therefore remove some of the restrictions on the type of illiquid assets in which investments may be made, and seek to address any unjustified barriers to retail investors investing in a broader range of long-term assets in unit-linked funds.

The amended rules add new "conditional permitted links", which insurers may use if they are able to meet conditions providing an enhanced degree of investor protection. Insurers may continue to use the existing permitted links rules if they choose. The amended rules also introduce a new amalgamated limit for firms choosing to invest in conditional permitted links such that overall investments in illiquid assets in a linked fund should comprise no more than 35% of total assets.

Firms investing in conditional permitted links can exceed the pre-existing limits for individual permitted links categories as long as they do not exceed the overall threshold limit.

The amended rules therefore remove some of the restrictions on the type of illiquid assets in which investments may be made, and seek to address any unjustified barriers to retail investors investing in a broader range of long-term assets in unit-linked funds. The FCA originally consulted on the changes in December 2018 following recommendations by the Law Commission and engagement with the Treasury's Pension Scheme Investments Taskforce regarding potential regulatory barriers to investment in some less liquid or illiquid assets (including, for example, investment in infrastructure, loans secured on infrastructure assets, and some less liquid securities).

The new rules apply only where insurers choose to take advantage of the new "conditional permitted links", which took effect on 4 March 2020.

Supervision: FCA Dear CEO Letters Set Out Regulatory Focus Areas for the Year Ahead

Throughout January and February 2020, the FCA published a series of Dear CEO letters it sent to financial advisers, asset managers, alternative investment firms, and platforms. The letters set out the FCA's supervisory focus areas and highlight what the FCA views as key risk areas for firms operating in these sectors. Although not aimed specifically at private banks, aspects of these letters will be relevant to the private banking sector. Key themes explored in the letters include governance, operational resilience, and outsourcing.

The FCA has concerns about standards of governance, particularly regarding how firms ensure that suitability and appropriateness are considered adequately when it comes to high-risk investments. The FCA wants to make certain that clients are only opted-up to professional client status when appropriate, and that firms are placing a clear focus on acting in the best interests of their clients.

Key themes explored in the letters include governance, operational resilience, and outsourcing.

The FCA underscores the importance of the MiFID II product governance requirements, and emphasises how firms need to ensure that customer interests remain central throughout the product lifecycle.

The FCA has begun a review of how firms have implemented the product governance rules, and says it expects to complete this work early this year.

Regarding technology-based risks, the FCA focuses on both business continuity issues with existing services and poorly planned and executed technology migrations and upgrades. The FCA emphasises that there will be individual accountability under the SMCR for operational resilience failings. It warns firms that they must ensure that change programmes are adequately planned and thoroughly tested, and that clear responsibilities are defined up-front with any third parties.

The FCA also explains that firms need to have clear contractual arrangements and plans in place with outsourced service providers, and that they should undertake reviews of outsourcing arrangements to ensure the service provider is performing its services to a proper standard.

The letters indicate which areas the FCA might choose to focus on as part of its 2020/21 Business Plan, which is due to be published shortly. They also highlight that the FCA will be looking to ensure that firms take account of its expectations as set out in the letters, and that the FCA will use the SMCR to engage directly with accountable individuals in areas of concern.

Lessons From Enforcement: Principles Remain Key

On 12 February 2020, the FCA's Executive Director of Enforcement and Market Oversight, Mark Steward, delivered a speech on penalties, remediation, and the FCA's Principles for Businesses.

The speech focuses on the importance of the FCA's Principles for Businesses, and highlights that most of the FCA's recent enforcement cases involved serious breaches of the Principles concerning, for example:

- A lack of skill, care, and diligence (Principle 2)
- Poor systems and controls (Principle 3)
- Poor judgement, especially in reporting misconduct to the FCA (Principle 11)
- Unfair treatment of customers (Principle 6)

The speech emphasises that, although the Principles are broad and general in nature, these types of obligations are not satisfied by accident.

Mr Steward explains that, in these cases, there was no evidence that the Principles had been used to test or measure conduct, to measure systems and controls that were being put in place, or to identify or address the inadequacies of the conduct that occurred. Neither the firms in question nor their senior management engaged directly or explicitly with the Principles for Businesses in deciding, carrying out, or managing the conduct that led to the breaches in question.

Mr Steward highlights that, in many cases, misconduct is not apparent to the firm until significant harm is also apparent. Often this is because there is no evidence that the Principles were used to guide decision-making from the outset, or to oversee relevant functions, outcomes, or consequences, especially for consumers.

The speech emphasises that, although the Principles are broad and general in nature, these types of obligations are not satisfied by accident; they require deliberate and intended thought, planning, and organisation. Consequently, they should be an integral part of the operational process of planning or decision-making at all levels, and a way of overseeing and assessing whether the firm's conduct remains appropriate. Mr Steward urges firms and their senior management to approach business activities from the outset using the Principles as a foundational guide, as part of the organisation of activities and as a way of monitoring the execution of activities.

This is an important reminder for all firms, including private banks, to consider the Principles carefully as part of both their everyday planning and monitoring processes.

TechTrends: FCA Call for Input on Open Finance

In December 2019, the FCA launched a call for input on Open Finance. This follows the introduction of Open Banking in September 2019 under the revised Payment Services Directive (PSD2).

Open Banking enables customers holding a payment account at any EU bank, e-money issuer, or payment institution to require the account provider (known as an Account Servicing Payment Service Provider, or ASPSP) to share account data and payment functionality with licensed third-party service providers (TPPs).

TPPs are often new and innovative businesses offering applications and services that enable customers to view their banking data in different ways, but individual banks may also be providing TPP services. These applications and services might range from consolidated dashboards showing information across multiple accounts held with different ASPSPs to fast and convenient ways to initiate and track payments. The shift from ASPSPs owning customer data to customers being in charge of their own data with the ability to share it with third parties could bring down barriers to entry in the payments and money management space. Private banks will already be mindful of the impact this could have on their business.

The FCA's call for input on Open Finance takes stock of the developments in Open Banking, and assesses whether the same model could be implemented across the wider financial services landscape and beyond, to empower customers to take control of their finances. While the FCA is not pre-judging the outcome of the call for input, the FCA sees clear customer benefits in the concept of Open Finance and wants to be at the forefront of developments globally, in the same way that the UK championed Open Banking under PSD2.

According to the FCA, under Open Finance, a TPP could do two things:

- Collect a customer's financial data to present it to them or to a third party ("read" access)
- Undertake or initiate transactions on the customer's behalf (*e.g.*, initiating payments, switching accounts, making an investment, applying for credit) and presenting the data back to customers ("write" access), as well as receiving any necessary permissions

The FCA supports standardised API access for Open Finance because, in its view, standardised API access reduces barriers to entry (as third parties do not have to integrate on a firm-by-firm basis) and enhances security across the industry.

The FCA envisages that the benefits from Open Finance might include:

- Personal financial management dashboards
- Automating switching and renewals, encouraging shopping around in the interests of the consumer
- New advice and financial support services
- Digitalisation of data, giving firms new capabilities in terms of understanding and servicing their customers, and managing risk
- More accurate creditworthiness assessments and increasing access to credit

However, there are still various unanswered questions about how Open Finance might work from a regulatory perspective. For example, without legislative change, many of the activities of TPPs under Open Finance would be unregulated. The FCA suggests that similar regulation to that of TPPs under PSD2 would be beneficial. Further, to facilitate Open Banking, ASPSPs are subject to requirements under PSD2 to ensure that they cooperate with TPPs. Similar requirements would likely be imposed on incumbent financial institutions under any Open Finance initiative, as without such requirements it may be difficult to facilitate the access required by TPPs. There is also the fundamental question as to which party would be responsible for errors and fraud. As a starting point, the FCA has proposed a draft set of Open Finance principles to support the development of Open Finance, which it plans to finalise following extensive industry consultation, and in coordination with the government.

The FCA is aiming to address four key questions through the call for input:

- **Incentives** — Will Open Finance develop without intervention? Crucially, do the incentives exist for established firms to provide access?
- **Feasibility and cost** — Can all firms develop and offer the access needed to support Open Finance? What are the costs and barriers involved?
- **Interoperability and cohesion** — What common standards are required for Open Finance to develop?
- **Clear data rights** — Is an adequate framework of data rights in place? If not, what would the framework look like, and how would it be provided?

The answers to these questions will be crucial in informing the FCA's approach to Open Finance, and industry engagement will be critical in developing the framework for Open Finance and the principles that underpin it. The call for input will close on 1 October 2020, delayed from 17 March 2020. Private banks should engage with the regulator's discussions at an early stage, to ensure that they follow developments closely. As with Open Banking, Open Finance provides new opportunities for incumbents, but also presents a risk of being overshadowed by new offerings from TPPs — and so private banks will want to consider how they might capitalise on the prospects that Open Finance might bring.

Global Insights: Singapore

On 14 February 2020, the Monetary Authority of Singapore (the MAS) published an information paper highlighting the practices and supervisory expectations that financial institutions operating in the private banking industry should benchmark themselves against. The paper is based on the MAS' thematic inspections on the sales and advisory practices of selected financial institutions over 2018 and 2019.

The paper highlights key practices that private banks should observe in the following categories:

- Governance by the board and senior management (*e.g.*, establishing clear accountability and responsibility over sales and advisory activities, including pricing issues and oversight of a product's lifecycle)
- Pricing controls and disclosure (*e.g.*, implementing adequate and effective pre-trade controls to prevent, and post-trade checks and surveillance to monitor and detect, unauthorised deviations from fee schedules and bilaterally agreed pricing arrangements)
- Investment suitability (*e.g.*, client risk-profiling, pre-trade investment suitability checks, and post-trade surveillance)

Private banks operating in Singapore should assess the ability of their internal controls and processes to meet these expectations effectively. Where there are gaps, private banks should address them in a manner appropriate for their context, taking into account their business model and risk profile.

What to Look Out for in Q2 2020

- Deadline for the EU and the UK to agree to any extension to the Brexit transitional period
- Joint Committee of the ESAs expected to submit its proposed amendments to the PRIIPs KID RTS to the European Commission for endorsement
- New FCA Financial Services Directory due to go live for banks and insurers
- ESMA expected to submit its Final Report on the MAR review to the Commission

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