LATHAM & WATKINS

10 Key Focus Areas

for UK-Regulated Financial Services Firms in 2021

Focus Areas

In last year's publication we highlighted the top regulatory focus areas for our clients during 2020, concentrating on wholesale market structures and conduct risk.

This publication outlines the primary focus areas in 2021 for UK-regulated financial services firms. Some of these topics are attracting attention because they are an emerging trend, or because they are at a key stage in the regulatory change or implementation cycle. Other topics are attracting attention as they are drawing industry and supervisory scrutiny due to uncertainty and inconsistency in their recent implementation, and require industry harmonisation.

While many of last year's topics remain relevant for this year, Brexit is likely to remain a key priority as the UK sets out its own regulatory regimes. Other issues will also continue to take centre stage such as climate change and conduct and culture. Scroll through or select a topic below.

1 Brexit

Brexit is likely to remain a key priority for many UK-regulated financial services firms in 2021. In part, this area of focus will be driven by the loss of licensing and the lack of reciprocal equivalence measures. Firms will need to get into the habit of working more closely with colleagues on the Continent and navigating local solicitation regimes.

Moreover, firms will need to ensure that they are ready for the way in which the UK regime will change. Such routine items as domestic transaction reporting protocols will need to be tweaked, and compliance manuals may need to be amended. Firms may not have read as many headlines about these topics.

However, there are three particularly uncertain future developments that firms will need to be ready to react to, including:

1. How markets and clients will adapt to the new environment. Will the share and derivatives trading obligations actually split European liquidity? Will EU-based clients take a different view on points that UK firms had hoped were settled?

2. How the UK will react to in-flight European regulatory changes. Regulatory frameworks such as MIFID and MAR are going to change in the EU over the course of 2021 and 2022. The current UK administration is unlikely to agree to follow European changes as a matter of course. So presumably, the UK will run consultations of its own in parallel to decide whether to adopt changes enacted at a European level — or alter those changes to produce a UK-specific regime (see Key Focus Area 2, in relation to MiFID). The approach the UK takes may depend on the topic — it makes more sense for the UK to stay aligned with the EU in areas where little competitive advantage could be gained through change (such as MAR), and less sense to do so in areas where different financial centres have traditionally competed (such as listing rules).

3. How the consultation on the scope of the overseas persons regime will influence any changes to the current UK regime. HM Treasury launched a call for evidence on the overseas framework on 15 December 2020 that will run until 11 March 2021. It is difficult to see how any changes could produce a more liberal position. The options for the UK appear to be adhering to the status quo (perhaps with some clarification(s), if possible) or introducing changes to make the position more restrictive (perhaps for those doing business with retail clients, or of a generally retail nature).

Brexit's implications will continue to be felt in the UK throughout 2021.

2 MiFID Refit

Two sets of proposals will be finalised in 2021 at a European level that will change MiFID in the near future. The first proposal is the planned MiFID refit exercise launched by the European Commission in February 2020. The second proposal is a COVID-19-led series of “quick-fix” liberalisations announced by the European Commission in July 2020. Together, as a package, MiFID in Europe is going to change.

It is tempting to say that the UK will follow suit with the changes to MiFID in Europe — how could it not follow any liberalisation undertaken at a European level? But some of the changes are out of line with the FCA’s traditional approach. The FCA is still seen as the champion of research unbundling. It would be a major step down for the FCA to make significant changes in this area. But that is what appears to be under consideration, a fact that the industry is likely to welcome. We may see, by the end of 2021, UK proposals that would bring about significant changes to the provision of investment research in the fixed-income and SME space.

Likewise, overdue changes to the costs and charges disclosure requirements and best execution requirements are likely to be in train. Whether these changes come into force over the course of 2021 remains to be seen. But if the FCA proposes changes in these areas, firms may worry less about the extent to which their compliance reaches their usual standards.

Finally, product governance may finally shrink (somewhat) to fit the task it was originally intended to achieve. A carveout for all securities, or at least vanilla bonds (whether or not they contain a make-whole provision), would be an important step forward. In relation to equities, the market appears to have evolved to cope with product governance. As far as corporate bonds are concerned, the primary market has largely been closed to retail (partly as a result of PRIIPs). This is an area where rule changes in 2021 would challenge the industry-led approach that corporate bonds is a professional-only game.

3 MAR

The coming year is unlikely to see any alteration to the definitions of the conduct that is prohibited (and permitted) under MAR. The UK has not yet undertaken a wide review of the workings of MAR, in part because the FCA appears to be content with the regime. However, COVID-19 has led the FCA to make a number of statements about inside information, including in its Market Watch 63, published in June 2020. In short, more inside information will have existed in 2020 (due to, for example, a significantly greater number of distressed investee company situations), under less closely controlled conditions (due to home working) than ever before.

In 2021, we may see the FCA start to take action where it thinks that the new standard — that the control environment around home working needs to be equivalent to that for office working, a subject that was mentioned by Julia Hoggett, Director of Market Oversight at the FCA, in a speech in October 2020 — has, or has not been met.

At a European level, we may see legislative confirmation of the statements from ESMA published in its MAR review report in September 2020 that the market soundings regime is compulsory, rather than being a safe harbour. Such confirmation is likely to have little impact within the EU, where the regime is commonly followed, but may be a greater challenge for firms operating internationally.

4 Conduct and Culture

Conduct and culture could not be said to be new topics for 2021 by any stretch. But they are likely to continue to evolve. Just the as the FCA has grabbed attention in the past with statements relating to the responsibility of managers for the mental health of employees, or on the challenges of home working (and even returning to office working), these are topics that are unlikely to stand still. In our view, the link between the UK's Senior Managers and Certification Regime (SMCR) and the FCA's conduct and culture agenda is likely to continue to tighten, perhaps illustrated by enforcement cases (see Key Focus Area 5).

Non-financial misconduct will likely remain a key area of focus for the FCA, which recently barred three individuals from working in the financial services industry following findings that they were not fit and proper after they had been convicted of non-financial indictable offences. Likewise, the efficacy of firms' whistleblowing arrangements will likely remain a key area of focus for the FCA. Both are inextricably linked to culture.

We expect more firms to be implementing behavioural training for managers, emphasising empathy, self-awareness, and self-reflection. We also anticipate enhanced transparency around promotion metrics — a clear "engine room" expectation, as the FCA recently reported in its latest conduct and culture update.

The impact of the COVID-19 pandemic has sharpened the focus on organisational culture and the social and governance aspects of ESG, making it more crucial than ever for organisations to be aware of heightened regulatory scrutiny across regions and industries.

In light of the increased focus on corporate culture, Latham & Watkins has published the second edition of Culture — A Practical Framework for Sustainable Change. Informed by the latest insights, trends, and case studies, the framework helps bridge the divide between theory and practice, guiding organisations on their own practical approach to cultural progression. While there may never be a "perfect" methodology for measuring culture, there is an array of measures and techniques that institutions can usefully adopt in their quest to institute a meaningful, objectively monitorable, and operationally workable culture change programme.

5 Enforcement Against Senior Managers

The SMCR is entering its fifth year. In 2021, we may, therefore, see a number of SMCR-related enforcement cases announced, including, potentially, an appeal from the Upper Tribunal as mentioned in the PRA's findings on its evaluation of the SMCR, published in December 2020.

Let us hope that these enforcement cases are instructive in helping to illustrate what is, and is not, acceptable conduct by a senior manager seeking to discharge their managerial duties. The FCA tends to prefer open-and-shut cases when it first enforces a new regime, for understandable reasons.

This may be an area in which the FCA chooses to take a different path. Whilst better guidance on behavioural standards and conduct breach reporting would be welcome over the course of 2021, there is no doubt in our minds that a leading case would be the big event in this field.

6 ESG

Environmental, Social and Governance (ESG) has come a long way as a regulatory topic in a short period of time in multiple jurisdictions globally. We think 2021 will be the year that ESG will truly come of age. Regulators and legislators have already laid the groundwork to enable them to require firms to truly engage with this topic on a scale perhaps not previously envisaged. But more than this, clients and other stakeholders will force firms to truly engage with ESG as well. It will be easier for firms to grab hold of this agenda and do their own work than be buffeted at a later date by the twin winds of regulatory will and client/stakeholder power.

In the early part of 2021, firms in scope of the EU SFDR (Level 1 applying from 10 March 2021) will need to monitor the FCA's planned consultation for the UK version and decide how to consider the operation of both regimes side by side. The same is true of the EU Taxonomy Regulation for which firms will need to prepare for the climate related implementation aspects in 2021, ahead of the 1 January 2022 implementation deadline. Last autumn, the UK Treasury announced its intentions to develop a UK green taxonomy in due course.

We expect to see a continuation of the focus on corporate culture as an integral factor within the "S" and "G" elements of ESG. Arguments that these aspects of ESG compliance are less metrics based and therefore more difficult to measure and report on than climate performance are starting to be disproved by some of the regulated institutions that are carving out a market-leading position in this space.

7 Prudential Reform

As a legislative event, the EU Investment Firm Directive and Regulation (IFD/R) is a big deal. A lot of words have to be written to make the changes necessary to adapt the existing bank-led regime for the investment firm market. These changes span a range of important topics, including capital requirements, governance, and remuneration. Not many regimes split opinions amongst peers as much as the IFD/R does. This is because changes to matters such as capital will produce different outcomes (both good and bad) for firms which, from the outside, look quite similar. Equally, scrapping the existing proportionality in relation to remuneration, and replacing it with cliff-edge limits, may mean winners and losers are created without a serious policy rationale behind it.

If there is one area in 2021 where firms are likely to lobby in different directions, IFD/R is it. As a result, the outcome of the UK implementation is probably less clear cut than many other regulatory reviews. Firms will need to follow CRD implementation all the way to the UK IFPR implementation date, which is likely to be 1 January 2022. Even this date will create winners and losers, depending upon year end and pay review timing.

Following on from its discussion paper published in June 2020, the FCA recently published a consultation on the first phase of its proposed rules to introduce the UK IFPR. The FCA plans to publish two further consultations in 2021.

8 Data

The financial services industry is, of course, highly data-led. Firms must consider, and are subject to, a wide range of global data rules — from invoking the DPA 2018 and GDPR in the processing of client and employee personal data to investment research and ESG (an area in which regulators are already murmuring about whether this could amount to the provision of credit ratings). The use of "big" or "alternative" data also poses a plethora of regulatory questions, including whether it is "fair" under the insider dealing rules.

The UK will shortly undertake its own FCA-led consultations on the extent to which the pricing of data is, or is not, in line with its expectations under the various "reasonable commercial bases" tests in regimes such as MiFID.

The FCA's consultation on the use of data under MAR is also underway, with a call for input launched in March 2020, although the deadline for responses was pushed back to January 2021 as a result of COVID-19. These areas are likely to start reaching their landing grounds in 2021.

9 Competition Risks

Over the past decade, certain financial services firms have experienced extensive "on the ground" training about competition law risks as a result of investigations by regulators (often multiple regulators in different jurisdictions) globally, like those into LIBOR and FX manipulation. In the UK, the FCA has taken enforcement action in relation to information exchange between asset managers during the IPO/placement book-building process market. And the competition team at the FCA has been an active contributor to both the policy and enforcement debates. However, it is probably fair to say that competition risks remain generally less well understood in the sector than, say, market abuse, despite the fact that competition risks and market abuse often overlap, which can create strategic tensions that need to be carefully managed.

When combined with the risks of follow-on damages claims, and a recent Supreme Court decision (making it more likely that a class action based redress approach will develop in the UK — similar in some ways to the system in the US, where class actions follow the merest suggestion of anti-competitive behaviour as night follows day), firms will want to ensure that they properly understand where their competition risks lie, and that senior managers can demonstrate that the businesses they are responsible for are actively policing those risks.

10 Biden

This year will see the start of the Biden presidency in the US. This may not seem like a significant event for the UK financial services industry. But over time it may develop into one.

A Biden SEC Chair may direct a more aggressive enforcement stance, especially towards large financial institutions. And the President-elect's approach to topics such as ESG is more likely to align with the European approach than that of his predecessor.

Whether a Biden presidency leads to new legislation, with potentially extraterritorial effect, remains to be seen.

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