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PRIVATE BANK BRIEFING

LATHAM & WATKINS

Issues Impacting the Private Bank Sector

Welcome to our quarterly roundup of legal and compliance issues impacting private banks and their clients.

In This Edition

Sustainable Finance: Recent Developments

EU SFDR: Commission Q&A

On 26 July 2021, the European Commission published its long-awaited Q&A on the EU Sustainable Finance Disclosure Regulation (SFDR), in response to queries raised by the European Supervisory Authorities (ESAs) (i.e., ESMA, EBA, and EIOPA). The questions raised by the ESAs encompassed many of the questions that market participants were grappling with as they tried to prepare for the regime coming into force on 10 March 2021. The ESAs raised questions in the following areas:

1. Does the SFDR apply to non-EU AIFMs and registered AIFMs (sub-threshold)?

Non-EU AIFMs: The Commission confirms that the SFDR does apply to non-EU AIFMs. However, the Q&A says the "AIFM must ensure compliance with [SFDR], including the financial product related provisions". No mention is made of the entity-level SFDR requirements, although the guidance says "including" the product-related provisions, which leaves the application of the entity-level requirements to non-EU AIFMs subject to ongoing uncertainty.

2. How should market participants apply the 500-employee threshold for principle adverse impact reporting at the entity level to parent undertakings of a large group?

500-employee criteria and groups: The Commission helpfully clarifies that the PASI disclosure for large groups should cover the activities of the parent undertaking only and not the entire group, unless the group includes subsidiaries that are themselves large FMPs, regardless of whether they are established inside or outside of the EU.

Comply or explain: The Commission clarifies that there is a distinction between the "comply" "principal adverse impacts" disclosure and the "explain" "adverse impacts" disclosure under Article 4, to introduce a more stringent disclosure mechanism. The practical consequence seems to be that an "explain" statement under Article 4 should go beyond a mere statement that the specific PASIs are not considered and should provide clear reasons as to why the FMP does not consider the degradation of the environment or social injustice through its investments.

3. What is the design and minimum criteria for Article 8 / 9 products?

The Q&A does not specify minimum sustainable investments or ESG investment thresholds/percentages for Article 8 or 9 products. The Commission notes that both Article 8 and 9 are neutral in terms of product design, investment strategies, and methodologies.

The key points are as follows:

Article 8 products: The Q&A largely repeats previous guidance and confirms that the integration of sustainability risks is not sufficient to create an Article 8 product, i.e., "[Article 8] does not prescribe certain elements such as the composition of investments or minimum investment threshold, the eligible investment targets, and neither does it determine eligible investing styles, investment tools, strategies or methodologies to be employed".

Article 9 products: The Commission clarifies that alongside sustainable investments, these products may also include investments "for certain specific purposes such as hedging or liquidity", which "in order to fit the overall…sustainable investments' objective, have to meet minimum environmental or social safeguards". This seems to suggest that the large majority of investments in an Article 9 product must be in sustainable investments, but that there is room to include other investments that meet environmental or social safeguards (presumably the DNSH test) and "neutral investments".

4. What constitutes promotion of environmental or social characteristics under Article 8 of SFDR?

The Commission has taken the view that compliance with restrictions laid down by law can result in an Article 8 product, if they are "promoted" in the investment policy of the product.

The Commission defines promotion very broadly to include, by way of example: "an impression that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives" and is not limited to "pre-contractual and periodic documents or marketing communications".

Interestingly, the Commission does not reference materiality/significance, which is unhelpful with respect to products that apply only baseline sector exclusions and wish to avoid becoming Article 8.

5. How should market participants apply Article 9 SFDR and LCBR benchmarks?

The Commission states that the requirements of the LCBR must "be applied in conjunction with SFDR", and in particular the sustainable investments definition, which seems to indicate that both the LCBR criteria, and the SFDR sustainable investments test, should be applied for Article 9 products using an EU Paris Aligned or Climate Transition Benchmark.

In relation to whether an Article 9 product with a reduction in carbon emissions objective must track an EU Climate Transition or Paris Aligned Benchmark, the Commission has noted that Article 9(3) of the SFDR would require the product to track these benchmarks if they exist.

6. How should market participants apply SFDR product rules to managed portfolios/separate accounts and website disclosures?

The Commission notes that the SFDR does not distinguish between tailored and standardised products and states that website disclosures "must ensure compliance with Union and national law governing the data protection, and where relevant, also ensure confidentiality owed to clients".

Further, the Commission states that FMPs that make use of "standardised product solutions" could give transparency on these, which "might be a way" of complying with the website disclosure requirement. This statement seems to provide some grounds for providing standardised website disclosures where possible (e.g., at centrally managed strategy level), even with respect to individual services like managed accounts.

FCA Guiding Principles

On 19 July 2021, the FCA published a letter to chairs of authorised fund managers setting out its expectations on the design, delivery, and disclosure of ESG and sustainable investment funds. The letter brings welcome clarity on the FCA's supervisory approach to funds that focus, or claim to focus, on sustainability, as the FCA is concerned that many such funds are being marketed to investors without adequately substantiating or explaining the fund's investment strategy and goals, creating risks of greenwashing and misleading investors.

The annex of the letter sets out guiding principles (the Principles) to help firms comply with existing requirements for designing (or repositioning) and marketing their products in a responsible way. These Principles are derived from the FCA's existing approach to fund classification and its existing disclosure rules. They have implications for product design, resourcing, and managing the ESG elements of a fund's strategy and marketing, which are relevant for AFMs managing both private and authorised funds in terms of the supervisory expectations from the FCA.

The guiding principles comprise an overarching principle and three supporting principles. Each principle is accompanied by a set of key considerations. The overarching principle is consistency: a fund's ESG/sustainability focus should be reflected consistently in its design, delivery, and disclosure. Further, a fund's focus on ESG/sustainability should be reflected consistently in its name, stated objectives, documented investment policy and strategy, and holdings.

The three Principles are as follows:

- **Principle 1: The design of responsible or sustainable investment funds and disclosure of key design elements in fund documentation.** References to ESG (or related terms) in a fund's name, offering documentation, or marketing material should fairly reflect the materiality of ESG/sustainability considerations to the objectives and/or investment policy and strategy of the fund.
- **Principle 2: The delivery of ESG investment funds and ongoing monitoring of holdings.** Here, the resources (including skills, experience, technology, research, data, and analytical tools) that a firm applies in pursuit of a fund's stated ESG objective should be appropriate so that the fund is reasonably capable of achieving its stated objective. Further, the fund's investment strategy and holdings should be consistent with its disclosed objectives on an ongoing basis.
- **Principle 3: Pre-contractual and ongoing periodic disclosures on responsible or sustainable investment funds should be easily available to consumers and contain information that helps them make investment decisions.** ESG and sustainability-related information in a KID should be easily available and clear, succinct, and comprehensible, avoiding the use of jargon. Funds should disclose information to enable consumers to make an informed judgment about the merits of investing in a fund. Periodic fund disclosures should include evaluation against stated ESG/sustainability characteristics, themes, or outcomes, as well as evidence of actions taken in pursuit of the fund's stated aims.

IOSCO consultation on ESG ratings and data providers

On 26 July 2021, the Board of the International Organization of Securities Commissions (IOSCO) solicited feedback on a set of proposed recommendations regarding ESG ratings and data providers. The consultation aims to assist IOSCO members in understanding implications of the activities of ESG ratings and data providers and in establishing frameworks to mitigate risks stemming from these activities. The consultation also proposes a set of recommendations to mitigate these risks and address some of the challenges faced by users of products and services from ESG ratings and data providers, and the companies that are the subject of these ESG ratings and data products.

The recommendations proposed by IOSCO include:

- Regulators may wish to consider whether their existing regulatory regimes provide sufficient oversight of ESG ratings and data products providers in their jurisdictions
- Whether regulators have the relevant supervisory authority and if they wish to consider whether data, information sources, and methodologies should be publicly disclosed

Separately, in relation to users of ESG ratings and data products, IOSCO is seeking feedback on recommendations including FMPs to consider conducting due diligence on the ESG ratings and data products they use in their internal processes.

In relation to recommendations aimed at entities subject to ESG ratings and data products providers, IOSCO suggests that companies designate a dedicated internal point of contact to address any requests from or queries to providers. In the past, users have signalled that having multiple ESG ratings and data products can cause confusion, raising serious questions about relevance, reliability, and greenwashing.

Further, the Commission indicated in its Renewed Sustainable Finance Strategy that it will undertake efforts to improve the reliability and comparability of ESG ratings, which will help drive improvements in the assessment of ESG risks. The Commission may also assess whether a similar intervention is necessary in relation to ESG market research.

MiFID: UK "Quick Fix" Changes

On 30 June 2021, HM Treasury published the Markets in Financial Instruments (Capital Markets) (Amendment) Regulations 2021. The Regulations amend the UK onshored version of the MiFID II Delegated Regulation on organisational requirements to implement various amendments that reflect, but do not mirror exactly, some of the EU MiFID quick fix changes.

The changes include:

- Making electronic communications the default method for wholesale clients (HM Treasury plans to consult on whether to make this change for retail clients)
- Allowing information on costs and charges to be provided after a transaction is concluded when it is concluded by means of distance communication
- Removing requirements to provide detailed order confirmations and quarterly portfolio management reports to wholesale clients (HM Treasury plans to consult on whether these requirements should be removed for retail clients)
- Removing the obligation to provide 10% depreciation reports to wholesale clients (HM Treasury plans to consult on whether to remove this requirement for retail clients)
- Removing the requirement for firms to provide information about their services before they are carried out, where services are provided to eligible counterparties
- Removing the requirement for investment firms to produce best execution reports, complementing the FCA's proposals in CP21/9 by making the necessary legislative changes

Most of the changes came into force on 26 July 2021, except the changes regarding best execution reports, which will come into force on 1 December 2021. Private banks should consider the amendments needed to client policies and procedures to reflect the changes, bearing in mind that the UK changes are not exactly the same as the forthcoming EU changes, which will apply from 28 February 2022.

PRIIPs: FCA Consults on Changes to UK PRIIPs Regulation

On 20 July 2021, the FCA published a Consultation Paper (CP21/23) on amending the UK PRIIPs Regulation. The FCA has long held concerns about the PRIIPs framework, and pre-Brexit had been heavily involved in efforts to persuade EU lawmakers to amend the rules. Now that the FCA has the flexibility to amend the regime, the regulator is looking at how it can address some of the most serious concerns.

The Financial Services Act 2021 made some changes to the UK PRIIPs framework, which allow the FCA to specify whether a product can be classified as a PRIIP, and replace the requirement to include performance scenarios in the KID with a requirement to include information on performance.

The FCA is consulting on changes to its rules that would:

- Clarify the scope of the UK PRIIPs Regulation by making clear which features of corporate bonds would/would not bring them within scope. For example, the FCA intends to clarify that a debt security will not be a PRIIP if the overall return for the investor is determined by the economic performance of the commercial or industrial activities of the issuer, or simply because it has a fixed coupon, it includes a put or call option (provided the option is not exercisable in response to fluctuations in reference values or the performance of one or more investment assets), or it has a perpetual or indefinite term.
- Specify that PRIIP manufacturers meeting certain conditions would not be considered to be making a PRIIP available to retail clients. These conditions would include: (i) the marketing materials make clear that the PRIIP is being offered only to investors eligible for categorisation as professional clients or eligible counterparties and that the PRIIP is not intended for retail investors; (ii) the marketing and distribution strategy for the PRIIP is in fact targeted at professional and eligible counterparty clients and not retail clients; and (iii) the PRIIP is issued at a minimum denomination value of £100,000 (or equivalent sum in foreign currency).
- Clarify that any financial instrument issued or sold before 1 January 2018 is not a PRIIP, even if it remains available for trading on a secondary market.
- Remove the requirement in the PRIIPs RTS for PRIIP manufacturers to include performance scenarios in the KID, and add a requirement to include a narrative description of performance.
- Introduce a requirement in the PRIIPs RTS requiring PRIIP manufacturers to upgrade a product's SRI if they consider that the risk rating produced by the current methodology is too low.
- Address specific issues arising from transaction cost reporting. The FCA's proposed changes address the treatment of anti-dilution benefits, the calculation of transaction costs for debt securities, the calculation of transaction costs for index-tracking funds, and the correct method for calculating average transaction costs.

The consultation runs until 30 September 2021, and the FCA plans for the changes to come into effect on 1 January 2022. For more detail, please see Latham's related blog post.

The FCA's proposed changes to the UK PRIIPs framework signal a conscious departure from the EU framework, which remains under review.

The timeframe for potential change in the EU is significantly longer, with the European Commission having only committed to complete its assessment of the framework by early 2022.

In the meantime, the Commission has adopted certain targeted changes to the PRIIPS RTS that are due to take effect from 1 July 2022. The revised version of the PRIIPs RTS (and accompanying Annexes) sets out: (i) new methodologies for calculating performance scenarios and a revised presentation format for performance scenarios; (ii) revised summary cost indicators and changes to the content and presentation of costs information; (iii) a modified methodology for the calculation of transaction costs; and (iv) modified rules for multi-option products.

Now that the FCA has the flexibility to amend the regime, the regulator is looking at how it can address some of the most serious concerns.

Consequently, private banks offering PRIIPs across UK and EU markets will need to be prepared to comply with differing requirements from as early as next year and will need to consider how to adapt their KID templates accordingly.

Remuneration: FCA Dear Chair of the Remuneration Committee Letter Focuses on Conduct and Diversity

On 3 August 2021, the FCA published a Dear Chair of the Remuneration Committee letter setting out its approach to remuneration for 2021/22 and highlighting areas for dual-regulated firms to consider.

The FCA expects firms to take considerations around diversity and inclusion into account where relevant even before the regulator develops a concrete policy framework.

In the letter, the FCA reminds Chairs that they should remain satisfied that their firm's remuneration policies are aligned with the firm's purpose, business strategy, and values, and that they incentivise the right behaviours. The FCA emphasises the role of remuneration in ensuring accountability and highlights that, for instances of poor behaviour or misconduct, appropriate and timely ex-post risk adjustments should be made. Further, the reasons for adjustments should be transparent to the individuals concerned.

The FCA expects to see more firms using non-financial measures in remuneration scorecards to support ESG factors, particularly the social element. The FCA urges firms to review pay data across all protected characteristics and to act swiftly to address any disparities, noting that increasing diversity and fostering an inclusive environment is a key element of a healthy culture.

The FCA expects firms to take considerations around diversity and inclusion into account where relevant even before the regulator develops a concrete policy framework. Private banks should be mindful of the link between remuneration practices and culture, and conscious of how their approach to remuneration may be perceived by the regulator.

Diversity: Regulators Launch Discussion on Diversity and Inclusion in Financial Services

On 7 July 2021, the FCA, the PRA, and the Bank of England published a joint Discussion Paper on diversity and inclusion in the financial sector. According to the regulators, research shows there is a positive correlation between increased diversity and inclusion and better outcomes in risk management, conduct, culture, and innovation.

In the Discussion Paper, the regulators consider diversity and inclusion not only in terms of how a firm is run internally, but also how the firm serves its customers. The purpose of the Discussion Paper is to explore how the regulators can accelerate the pace of meaningful change, and what role they can play in facilitating that change.

According to the regulators, research shows there is a positive correlation between increased diversity and inclusion and better outcomes in risk management, conduct, culture, and innovation.

The regulators use the paper to outline what future policy measures they might introduce. These include measures for firms to consider internally, such as expectations regarding governance, senior management, remuneration, and policies and procedures. They also include considerations for the regulators to incorporate into their supervisory approach, including how issues relating to diversity and inclusion could affect the suitability of individuals and firms for regulatory approval.

Key potential policy proposals include:

- Introducing specific targets for board representation
- Ensuring accountability for diversity and inclusion through the SMCR
- Expecting firms to use metrics linked to advancing diversity and inclusion as part of non-financial criteria when setting variable remuneration awards
- Requiring firms to have a diversity and inclusion policy and publish it on their website (although the contents of such policies would not be prescribed)
- Potentially expecting firms to set targets for representation and inclusion within boards, senior management, customer-facing roles, and/or the wider firm
- Requiring firms to publicly disclose a selection of aggregated diversity data on their senior management and employee populations as a whole

The regulators highlight that they may examine diversity and inclusion issues when: (i) assessing the fitness and propriety of individuals; (ii) considering applications for Senior Management Functions; and (iii) considering whether a firm continues to meet the Threshold Conditions.

The regulators are also planning on introducing regular reporting of employee data — most likely data on the protected characteristics and socioeconomic backgrounds of different categories of staff. The regulators plan to publish a Consultation Paper in Q1 2022, with final rules planned for Q3 2022. Private banks should consider their internal diversity and inclusion initiatives and how they are performing, in preparedness for greater regulatory scrutiny in this area.

For more detail, please see Latham's related blog post.

Financial Crime: FCA Warning of Risks Linked to Afghanistan

On 31 August 2021, the FCA published a new webpage with the aim of reminding firms to be vigilant about potential financial crime risks linked to Afghanistan. The FCA highlights that firms need to be aware of the possible impact recent events in Afghanistan may have when they assess risks related to particular customers and flows of funds.

The FCA emphasises that, whilst Afghanistan is not currently listed as a high-risk jurisdiction under the Money Laundering Regulations, firms are required to apply risk-sensitive due diligence measures where there is a high risk of money laundering or terrorist financing, and should consider country risks when assessing what level of due diligence to apply.

The FCA indicates that it expects firms to:

- Ensure that they appropriately monitor and assess transactions to Afghanistan to mitigate the risks of their firm being used for money laundering or terrorist financing
- Continue to ensure that suspicious activity is reported to the UK Financial Intelligence Unit and that they meet their obligations under relevant money laundering and terrorist financing legislation

The FCA also reminds firms that financial sanctions already apply in relation to Afghanistan, and firms should continue to ensure that they screen against the UK Sanctions List and have appropriate systems and controls in place to comply with the financial sanctions regime.

Private banks should review their anti-money laundering policies and procedures to ensure that they are considering the potential increase in financial crime, and appropriately addressing the relevant risks.

The FCA highlights that firms need to be aware of the possible impact recent events in Afghanistan may have when they assess risks related to particular customers and flows of funds.

However, private banks should also be aware that the FCA recently sent a letter to the Treasury Select Committee addressing concerns raised about banks de-risking by freezing bank accounts. In the letter, the FCA explains that if a bank considers freezing an account to be necessary, any investigation should be carried out in a reasonable timeframe and customers should not be denied access to their money unnecessarily. If a bank decides to withdraw its banking services it should communicate its decision to the customer, setting out clear reasoning where possible without alerting the customer in a way that may prejudice further action (i.e., tipping off). Consequently, private banks should also consider the FCA's guidance on de-risking when planning their response to the potential increased risk associated with Afghanistan, and ensure that they are treating customers fairly in their actions.

AML and CTF: A Roundup of Recent Developments in the UK and EU

Regulators in the UK and the EU have increasingly focused on implementing a variety of changes to their respective anti-money laundering (AML) and counter-terrorist financing (CTF) regimes. The direction of travel of each regime will be an important watch point for private banks post-Brexit. Key developments are summarised below.

EBA sets out proposed guidelines for AML and CTF compliance officers and management bodies

On 2 August 2021, the EBA published a Consultation Paper on guidelines on the role, tasks, and responsibilities of AML and CTF compliance officers and firms' management bodies with regard to AML and CTF. Once the guidelines are confirmed, they will apply to all firms in-scope of the Fourth Money Laundering Directive (MLD4). The closing date for comments on the Consultation Paper is 2 November 2021. A watch point for UK firms is whether the EBA proposals influence developments in the UK.

The Consultation Paper notes that MLD4 requires, where appropriate with regard to the size and nature of the business, that firms appoint a compliance officer at management level who is responsible for implementing the firm's AML and CTF policies and procedures and systems and controls. MLD4 further provides that firms with a management body should also identify a member of that body who is ultimately responsible for the implementation of, and compliance with, the rules. The Consultation Paper is aimed at clarifying each of these individuals' responsibilities, given that the EBA has observed divergence in Member States' implementation of these aspects of MLD4.

> Note that in the UK, under the Proceeds of Crime Act 2002 (POCA), firms are required to appoint a "nominated officer" to receive disclosures regarding knowledge or suspicion of the key money laundering offences under POCA. The Money Laundering Reporting Officer (MLRO) will often be a firm's nominated officer, but the roles can differ; the MLRO role is not created by statute (meaning it can vary between firms), and the two roles need not be performed by the same person.
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> As an overlay to POCA, the FCA requires firms to appoint a director or senior manager (SMF17) to whom overall responsibility for AML and CTF systems and controls is allocated. Firms must also appoint an MLRO, who should act as a "focal point" for the firm's AML and CTF activity.

The Consultation Paper aims to achieve consistency in the understanding of the management body's role in AML and CTF compliance as well as that of the individual senior manager ultimately responsible for AML and CTF. Notably:

- The senior manager should be the AML and CTF compliance officer's main contact point for AML and CTF issues and ensure that any concerns are duly addressed by the management body.
- The senior manager must ensure that recommendations approved by the management body result in adequate action to remedy the issues or breaches identified.
- The AML and CTF compliance officer must be appointed at a level where they have the power to propose, on their own initiative, all necessary or appropriate measures to ensure the effectiveness of the internal AML and CTF systems and controls to the management body.
- The guidelines specify the suitability, skills, and expertise requirements for the AML and CTF compliance officer as well as explain the duties and responsibilities of the role.
- The Consultation Paper recommends that national competent authorities should be able to request information to test the adequacy and effectiveness of the AML and CTF compliance officer function.

The Consultation Paper also states that where a firm is part of a group, a group AML and CTF compliance officer in the parent company should be appointed (in addition to entity-specific officers) to ensure the establishment and implementation of effective group-wide AML and CTF policies.

HM Treasury initiates post-Brexit review of the UK's AML and CTF regime

On 22 July 2021, HM Treasury published a Call for Evidence on a review of the UK's AML and CTF regulatory and supervisory regime as well as a Consultation Paper on amendments, to be made via statutory instrument in Spring 2022 (the SI), to the UK's key piece of AML and CTF legislation, the Money Laundering Regulations 2017 (MLRs 2017). Despite the fact that HM Treasury published the papers concurrently, they are "separate documents with distinct purposes".

The planned amendments to the MLRs 2017 by virtue of the SI are either "time-sensitive" or "relatively minor" and are proposals for change that were already in development. The SI will, therefore, be unaffected by the findings of the Call for Evidence, and any amendments to the MLRs 2017 resulting from the Call for Evidence will be made separately.

The Call for Evidence will review the UK's AML and CTF regime in three key workstreams:

1. Reviewing the overall effectiveness of the MLRs 2017, in particular by: (i) assessing the scope and extent of the regime and whether certain low-risk sectors may be de-scoped; and (ii) reviewing the evidence of recent enforcement action and if supervisors' current powers are effective and dissuasive.
2. Determining whether the regime is operating as intended with a focus on whether specific regulations support the aims of the MLRs 2017 or whether they represent a disproportionate burden. This includes reviewing the degree to which in-scope entities feel able, in practice, to take risk-based decisions, and any barriers to doing so given the MLRs 2017 are "deliberately not prescriptive" and are intended to provide flexibility in order to promote a proportionate and effective risk-based approach. It also includes reviewing: (i) whether the rules stipulating when enhanced and simplified due diligence can be applied are helpful or overly restrict firms' ability to take risk-based decisions; (ii) whether it would be helpful to simplify the rules on relying on another firm's client due diligence (CDD); and (iii) notably, the case for imposing new substantive legal obligations on supervisors (such as the FCA) to bring considerations of Suspicious Activity Reports (SARs) into the core of their activity and to explore the role supervisors can play in "driving up standards" in the quality of SARs. HM Treasury is considering: (i) requiring supervisors to review SARs submitted by their supervised population (such as all firms supervised for AML and CTF purposes by the FCA) as part of their wider assessments and/or to separately consider to what extent the quality and quantity of a firm's SARs reflect its own risk assessment; and (ii) expecting supervisors to use existing enforcement powers where they identify consistently poor behaviour relating to SARs.
3. Reviewing the structure of the supervisory regime and the interaction and effectiveness of the statutory and professional body AML and CTF supervisors.

The Consultation Paper considers amendments that are time-sensitive and are required to ensure that the UK continues to meet international standards and to clarify ambiguities following Brexit. The aim, therefore, is for the SI to be "very focused" and to include a number of specific measures. The most notable of these is the intention to introduce a "travel rule" to cryptoasset transfers to replicate, insofar as practicable, the rules applicable to bank transfers in the Funds Transfer Regulation to providers such that they must send and record information on the originator and beneficiary of cryptoasset transfers.

This travel rule will ensure that the UK complies with FATF Recommendation 16. Notably, therefore, whilst the mandatory addition of originator and beneficiary information to such transfers is a material change, it aligns with an approach the FATF recommends globally, such that the UK will not be an outlier.

The closing date for comments on the Call for Evidence and Consultation Paper is 14 October 2021. For more detail, see Latham's blog post.

EU Commission proposes an overhaul of EU AML and CTF rules

On 20 July 2021, the EU Commission published a package of proposals to update and amend the EU-wide Money Laundering Directives. The package includes:

1. A proposal for the creation of a new, central EU authority to combat money laundering and terrorist financing. The authority would establish a single, integrated system of AML and CTF supervision across the EU while also directly supervising "some of the riskiest financial institutions" that operate in a large number of Member States or require immediate action to address imminent risks. National competent authorities would still have AML and CTF supervisory responsibility, with the new regulator acting as the EU-wide "centrepiece".
2. A new regulation (rather than a directive) establishing an EU AML and CTF "Single Rulebook" by setting directly applicable rules on CDD and beneficial ownership in Member States, and an EU-wide limit of EUR 10,000 on large cash payments. The proposed regulation contains the majority of the day-to-day obligations that are currently contained in MLD4 but will be more detailed and granular than at present to ensure greater harmonisation. This is a key divergence watch point given part of HM Treasury's review in its Call for Evidence is whether the current UK AML and CTF regime (derived from MLD4) is, in fact, too prescriptive and prevents firms from taking a proportionate, risk-based approach. It may be, therefore, that the UK continues to prefer outcomes-based regulation post-Brexit compared to the increased specificity of the EU regime. However, the Commission has not adopted a maximum harmonisation approach meaning that Member States will be able to gold-plate the Single Rulebook where national risks justify doing so.
3. The new regulation will be complemented by a new Sixth Money Laundering Directive that will repeal and replace MLD4. However, the new directive no longer contains the substance of obliged entities' AML and CTF obligations (which have been moved to the regulation) and instead contains provisions that organise the AML and CTF powers of national competent authorities and the establishment of, and access to, national bank account and beneficial ownership registers (given Member States require more flexibility in these areas).
4. Revisions to the Transfer of Funds Regulation to include the travel rule for cryptoasset transfers; a watch point for firms will be the potential for divergence between the EU's proposals and the outcome of the UK's Call for Evidence (see above).
5. Full application of the EU AML and CTF rules to the entire crypto sector (i.e., extending the scope of the regime beyond cryptoasset exchange providers and custodian wallet providers) thereby requiring all service providers to conduct CDD on customers. The amendments would allow for full traceability of cryptoasset transfers, such as Bitcoin, as well as the prevention and detection of their possible use for money laundering or terrorist financing. In addition, anonymous cryptoasset wallets would be prohibited, applying EU AML and CTF rules in full to the crypto sector.

The Commission is hopeful for a speedy legislative process and the legislative package is currently anticipated to be adopted in 2022. The Commission's aim is that the new regulator will be established on 1 January 2023 and start the majority of its activities on 1 January 2024. From 1 January 2025 it will select the entities it proposes to supervise directly and publish a list of those institutions within a month. The regulator will then commence supervision in January 2026. The new regulation, directive and revisions to the Transfer of Funds Regulation are expected to enter into force by the end of 2025. Given the lead times, any revisions to the UK regime are likely to be in place long before these changes at EU level take effect.

FCA: Business Plan for 2021/22

On 15 July 2021, the FCA published its Business Plan for 2021/22, along with a speech made by Nikhil Rathi, FCA CEO, at a webinar to launch the Business Plan.

The FCA vows to be more innovative, assertive, and adaptive.

The Business Plan this year focuses less on planned FCA policy initiatives, since these are now set out in the biannual Regulatory Initiatives Grid. Instead, the Business Plan and accompanying speech articulate the FCA's new ethos. The FCA vows to be more innovative, assertive, and adaptive.

Innovative: The FCA is investing more in its data and technological capabilities, recognising that its success as a regulator is largely driven by the information it collects and how it uses that information. The FCA is planning to modernise its systems and migrate to the cloud, enabling the regulator to scale its operations and to share intelligence more easily within the FCA and with other regulators.

Assertive: Mr Rathi speaks of a regulator that is "tough, assertive, confident, decisive, agile" and of a culture that embraces risk and acts decisively. He says the FCA will be prepared to "test our powers to the limit" and that the FCA will not be afraid to take action, even if it may not always win. According to Mr Rathi, not winning a case "will not be seen as failure". In the past, says Mr Rathi, when the FCA's perception of risk prevented necessary action, the lack of action was more problematic than any potential consequence of such action. Mr Rathi indicates that the FCA will focus its attention in particular on authorisations and new business, as these are areas that the regulator perceives to carry significant risk. In terms of general supervision, the FCA warns

that firms should expect greater rigour on upholding high standards. The FCA highlights governance, conflicts of interest, and conduct as particular areas of focus, including considering diversity and inclusion as regulatory issues.

Adaptive: Mr Rathi emphasises the need for the FCA to constantly adapt to keep up with developments. In particular, as many issues intersect with one another, the FCA plans to shift its operating posture to one that prioritises the problem in front of it rather than splitting up problems by types of firms or sectors.

Mr Rathi also mentions that the FCA is keen to look at regulatory boundaries, saying:

> *[W]e may wish to consider whether high-net-worth sophisticated investors should attract the same protection as other consumers less used to investing and less able to bear losses. We may also want to examine whether definitions for sophisticated investors are sufficiently robust. We have a very liberal regime in the UK when it comes to defining an investor as 'sophisticated'.*

This ties in with comments Mr Rathi made in a recent letter, in which he mentions that the FCA considers the exemptions in the Financial Promotion Order for high-net-worth and sophisticated investors are a significant vulnerability in the financial promotions regime. The FCA believes that both the ability to self-certify qualification for the exemptions, and the thresholds in the exemptions, need to be addressed. However, as the exemptions are set in legislation, Mr Rathi notes that any changes would be a matter for the government and Parliament to address.

Private banks should take note of the FCA's new approach and be mindful of the regulator's attitude when interacting with the FCA. Private banks should also be aware of current considerations around the financial promotions regime and the possibility that some of the exemptions may be narrowed in future.

Enforcement: FCA Consults on Changes to its Decision-Making Process

On 29 July 2021, the FCA published a Consultation Paper (CP21/25) on a new approach to decision-making in relation to issuing statutory notices.

The FCA considers that this shift in responsibility will enable it to make faster and more effective decisions.

The FCA is consulting on moving some decision-making from its Regulatory Decisions Committee (RDC) to its Authorisations, Supervision and Enforcement Divisions, to give greater responsibility for decisions to senior members of FCA staff. As such, certain decisions would be taken either by a senior staff committee or by an individual FCA staff member. The FCA considers that this shift in responsibility will enable it to make faster and more effective decisions.

The types of decisions made by FCA staff would include:

- Imposing a requirement on a firm or varying its permissions by limiting or removing certain types of business
- Making a final decision in relation to a firm's application for authorisation or an individual's approval that has been challenged
- Making a final decision to cancel a firm's permissions when a firm does not meet the FCA's regulatory requirements
- Starting civil and/or criminal proceedings

The RDC will continue to make decisions in relation to contentious enforcement cases, if the FCA is proposing a disciplinary sanction or seeking to impose a prohibition order. The FCA emphasises that its proposals would continue to fulfil its legal obligations, which do not require separation between the investigation team and the decision maker, but do require that the decision that gives rise to the obligation to give a statutory notice is taken by a person not directly involved in establishing the evidence on which that decision is based.

The FCA is also proposing changes to its internal decision-making procedures, including:

- Reducing the size requirement for staff committees to two, rather than three, individuals
- For statutory notice decisions made by the FCA, limiting the ability to make oral (rather than written) representations to exceptional circumstances only, to enhance the speed of the process
- Removing the requirement for there to be urgency before the FCA can exercise certain own initiative powers (e.g., to impose a variation of permission or a requirement)

Finally, the FCA notes that when decisions are being made internally by the FCA, communications could be shared between staff recommending that action be taken and those responsible for a decision. This contrasts with the current position, whereby if the RDC is the decision-maker it will not meet with or discuss the matter while it is still ongoing with the FCA staff responsible for the case without other relevant parties being present or otherwise having the opportunity to respond.

While billed as a simple streamlining of the decision-making process, the proposed changes are significant and remove various procedural protections for firms.

The consultation closed on 17 September 2021. The FCA aims to publish a Policy Statement in or around November 2021, and envisages that the new framework will apply immediately. While billed as a simple streamlining of the decision-making process, the proposed changes are significant and remove various procedural protections for firms.

As such, the changes could greatly affect firms' experiences with the regulator. The consultation was announced in the FCA's Business Plan for 2021/22; in the accompanying speech, CEO Nikhil Rathi spoke of a more assertive FCA, one that is prepared to "test our powers to the limit". Private banks should be aware of this new ethos and consider how it might impact the regulator's actions.

Lessons from Enforcement: Upper Tribunal Rules on Non-Financial Misconduct

On 31 August 2021, the Upper Tribunal published its decision in *Jon Frensham v The Financial Conduct Authority*. The case concerned an appeal by Mr Frensham against the Decision Notice imposed on him by the FCA in October 2020, pursuant to which the FCA had removed his approved person status and imposed a full prohibition order, banning him from working in the financial services industry in future.

The judgment includes an important analysis of when an individual working in financial services may be found to lack integrity as a result of non-financial misconduct unrelated to their work.

Background

Mr Frensham was a financial adviser and ran his own business. The FCA had found that Mr Frensham lacked integrity and was not a fit and proper person as he had been convicted of a criminal offence and sentenced to 22 months in prison for attempting to meet a child under 16 following acts of sexual grooming.

Although the misconduct was not connected with his work, it had occurred while Mr Frensham was an approved person. The FCA found that Mr Frensham's deviation from the legal and ethical standards expected of someone in his position was fundamentally incompatible with his role as a financial adviser.

The FCA argued as part of its case on appeal that Mr Frensham also lacked integrity because he had failed to be open and transparent with the FCA. Specifically, the FCA noted that Mr Frensham had not informed the regulator of various matters, including an earlier arrest that led to the imposition of bail conditions, his arrest for the offence in question and remand in custody (during which he could not carry out his controlled functions for five weeks), and the decision of the Chartered Insurance Institute to refuse to renew his Statement of Professional Standing and to expel him from membership.

Mr Frensham contended that the FCA allowed irrelevant considerations to affect its judgment, and did not properly consider the fact that his conviction did not relate to his regulated activity and the conviction was not for an offence of dishonesty.

The judgment includes an important analysis of when an individual working in financial services may be found to lack integrity as a result of non-financial misconduct unrelated to their work.

The Decision

This is the first time that the Upper Tribunal had to consider a case in which the FCA was seeking a prohibition order against an individual based on that individual's conviction for a criminal offence not involving dishonesty, in circumstances where the behaviour concerned was unrelated to the individual's regulated activity.

The Upper Tribunal upheld the FCA's original decision, but not for the same reasons. Interestingly, the Upper Tribunal found that it would not have reached the same conclusion as the FCA had it considered Mr Frensham's conviction alone.

The Upper Tribunal examined in detail what is meant by integrity in this context, and set out some general factors that ought to be considered as part of an assessment of a regulated individual's fitness and propriety.

These included:

- Integrity is a broader concept than honesty. However, the question is not just whether the individual lacked integrity, but whether he or she lacked integrity in a way that is relevant to the ethical standards of the profession in question.
- Professionals may be held to a higher standard than the general public, but are not required to be paragons of virtue.
- The need for public trust in the profession means that some scrutiny of a person's private life is permitted, but only when conduct that is part of a person's private life realistically touches on their practice of the profession concerned.
- When considering the relevance of behaviour that takes place in a person's private life, the key issue is whether the behaviour concerned realistically engages the question as to whether the individual poses a risk to consumers and to confidence in the financial system.
- In considering that question, the decision-maker should consider whether public confidence in the profession would be harmed if the public, assumed to have knowledge of the facts, found that a person who behaved in a manner under scrutiny was able to continue to practice his or her profession.

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The Upper Tribunal held that the FCA's decision could be upheld because of the circumstances in which the offence was committed (Mr Frensham had been in breach of his bail conditions at the time) and due to Mr Frensham's failure to be open and cooperative with the FCA in a number of respects. The Upper Tribunal rejected the FCA's argument that Mr Frensham's conviction alone meant that he was at risk of disregarding his regulatory obligations.

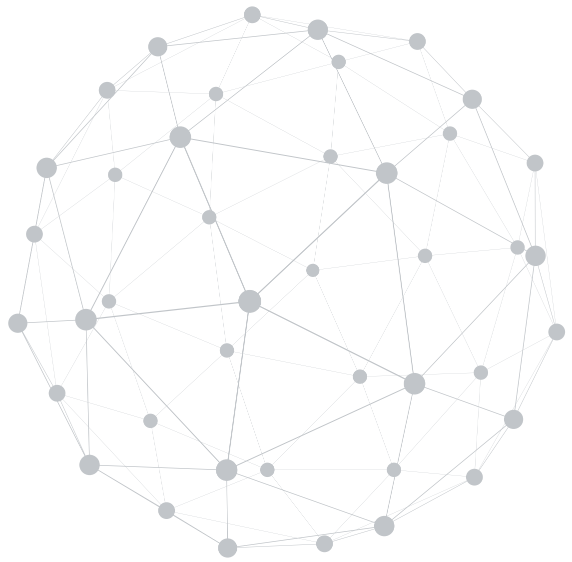
However, given Mr Frensham's lack of transparency with the FCA, and in particular the way in which he decided not to disclose certain information to the regulator because he deemed it unnecessary or thought it appropriate to keep certain matters back, the Upper Tribunal concluded that he did lack integrity. It stated, "We do have serious concerns that Mr Frensham will continue to put his own interests above his duty of candour and that he therefore continues to demonstrate a lack of integrity in this respect".

Commentary

The judgment is particularly interesting as it suggests that serious non-financial misconduct that occurs outside of the workplace will not necessarily lead to a finding that the individual concerned lacks fitness and propriety. The detailed consideration of the concept of integrity in this context is important as it provides guidance for firms grappling with difficult decisions in this area.

While every determination will be fact-specific, this case outlines some of the key parameters and key questions to ask when assessing the impact of non-financial misconduct on fitness and propriety. Private banks should ensure that relevant individuals responsible for considering non-financial misconduct internally are aware of this case.

TechTrends — The Rise of NFTs



The recent rise in popularity of non-fungible tokens (NFTs), one-of-a-kind cryptoassets stored on blockchain technology, presents a number of opportunities and new regulatory challenges. NFTs are not interchangeable and this is what creates their value, as each is unique

The blockchain acts as a decentralised ledger that tracks the ownership and transaction history of each NFT, which is coded to have a unique ID and other metadata that no other token can replicate. This process gives NFTs the attributes of originality and scarcity that makes them so attractive.

Almost anything can be a digital asset linked to an NFT. NFTs are particularly popular in creative sectors, and have evolved to encompass music, art, and even tweets. NFTs can be linked to physical works or can exist solely in the digital realm.

NFTs are being launched by a range of ventures, from artists to retailers and even sports teams, as they seek new revenue opportunities. NFTs can be used in a myriad of ways, including to create digital collectibles, to create new membership, subscription, and ticketing structures, as well as to monetise intellectual property rights. Investment in digital assets such as NFTs is likely to grow rapidly over the coming years, as investors become more comfortable with this new asset class and with investing in digital assets more generally.

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New kinds of service providers will be necessary to support the activity relating to NFTs, including custodians, payment service providers, and trading platforms. Private banks should be conscious of the interests of their clients in digital assets, and the type of assistance clients will want to support them with their investments. In this context, a key role will be undertaking custody of the assets — which is likely to involve managing and storing the private keys that control the assets on behalf of the owner. Both new fintech market entrants and existing custodial services providers are looking to offer these services, and so private banks will need to consider whether and how they wish to make custody of digital assets part of their offering.

Global Insights — Hong Kong

SFC confirms rules on climate-related disclosures for fund managers

On 20 August 2021, the Hong Kong Securities and Futures Commission (SFC) issued its consultation conclusions on the management and disclosure of climate-related risks by fund managers, making Hong Kong the latest jurisdiction to introduce an ESG-related disclosure regime in this sector.

The SFC has issued amendments to the Fund Manager Code of Conduct and a circular titled "Management and disclosure of climate-related risks by fund managers" setting out expected standards for fund managers to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures. Respondents to the consultation agreed with the proposal to make reference to the Task Force on Climate-related Financial Disclosures (TCFD) Recommendations in developing the new requirements, and implementing them using a two-tier approach.

All fund managers will have to meet the baseline requirements, and fund managers with assets under management of HK$8 billion or above (Large Fund Managers) will have to comply with enhanced standards. The baseline requirements cover four key elements, namely governance, investment management, risk management, and disclosure. The enhanced standards relate to risk management-related disclosures at entity or fund level and in relation to tools and metrics (e.g., calculation of portfolio carbon footprint).

The SFC expects fund managers to develop governance structures, policies, and procedures that are commensurate with the nature, size, complexity, and risk profiles of their firms and the investment strategies adopted by each fund. The SFC's requirements are applicable based on the relevance and materiality of climate-related risks to the investment strategies and funds managed by the fund managers as well as their roles.

In terms of implementation, Large Fund Managers have until the end of August 2022 to comply with the baseline requirements and the end of November 2022 to comply with the enhanced standards. Other fund managers have until the end of November 2022 to comply with the baseline requirements.

What to Look Out for in Q4 2021

- FCA to publish a Consultation Paper with proposed rules relating to the new Consumer Duty
- HM Treasury expected to launch a review of the disclosure regime for UK retail investors
- LIBOR cessation date
- PRA expected to publish first consultation on a new strong and simple prudential regime for smaller banks

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