ALLEN & OVERY

Financial Services and Markets Bill

Regulating CCPs and CSDs

The Financial Services and Markets Bill establishes a new framework for the Bank of England's regulation of Financial Market Infrastructure (FMI) and in particular central counterparties (CCPs) and central securities depositories (CSDs). Whilst many of these provisions are relevant simply to CCPs, CSDs, their legal, compliance and senior management teams, some will have a broader impact. They will also be of interest to material users of such infrastructure.

The Financial Services and Markets Bill also gives the Financial Conduct Authority (FCA) general rule-making powers over data reporting service providers and recognised investment exchanges (RIEs), but this is beyond the scope of this bulletin.

The "FSMA-ification" of CCP and CSD Regulation

The Financial Services and Markets Bill (FSM Bill) furthers the move to a model of regulation established by the Financial Services and Markets Act 2000 (FSMA), where the setting of regulatory and technical standards is delegated to expert regulators. In this model, the regulators' day to day experience of supervising financial services firms is central to the regulatory policy making process and provides flexibility for the regulators to update standards efficiently.

The principal pieces of legislation currently regulating CCPs and CSDs are the European Market Infrastructure Regulation (EMIR) and Central Securities Depositories Regulation (CSDR) respectively.

Each of these provides for many of the technical standards for CCPs and CSDs to be imposed through delegated legislation. Under the onshoring process, the responsibility for these technical standards was transferred to the Bank of England, as regulator and supervisor of these FMI.

Conversely, EMIR and CSDR themselves now have the status of "retained direct principal EU legislation" and can only be amended in ways similar to domestic primary legislation; by an Act of Parliament or, in limited cases, by statutory instrument made by HM Treasury.

The 'FSMA model' will revoke this retained EU legislation and replace it with the regulator's rules. The **FSM Bill paves the way for this revocation and restatement** and grants the Bank of England greater rule-making powers over CCPs and CSDs.

Scope of Bank of England's rule making powers

The Bank is empowered to make such rules applying to CCPs and CSDs as appear to it to be "necessary or expedient" for the purpose of advancing its statutory objective – that of protecting and enhancing the stability of the financial system of the UK.

Rules may relate to the carrying on of regulated activities or an activity which is not a regulated activity. The FSM Bill also provides the Bank with a power to impose requirements on individual CCPs and CSDs.

This greater power is subject to a new accountability and transparency framework.

Not just UK CCPs and CSDs

In certain circumstances, the Bank will be able to apply its rules not just to UK CCPs and CSDs but also to third country CCPs and CSDs.

The FSM Bill introduces a definition of a "systemic third country CCP" – any third country central counterparty that the Bank has determined is systemically important or is likely to become systemically important to the financial stability of the UK.

The criteria for determining systemic importance will be set out by HMT in secondary legislation. The explanatory memorandum accompanying the FSM Bill states that HMT intends this to be no more prescriptive than the current framework under EMIR. The Bank will be able to set out more detailed considerations in a statement of policy.

This is said to "allow the Bank to continue to operate its tiering framework as set out in its policy statement of 30 June 2022".

The FSM Bill grants the Bank a standing power to apply its domestic rulebook to a systemic third country CCP, in part or entirely and with such modifications as appropriate to ensure their effectiveness. Again, this seeks to maintain the effect of the existing regime where CCPs headquartered outside the UK may be subject to UK rules if they are deemed systemically important.

For third country CSDs, and for third country CCPs that have not been determined to be systemically important, HMT is able by further specific regulation to grant the Bank further powers to apply its rules to such firms, should it deem it necessary in the future. The Bank will only be able to apply its rules to such third country entities as so authorised.

Statutory objectives, regulatory principles and "have regards" obligations

Financial stability remains the Bank's sole primary objective but the FSM Bill expands that objective to expressly capture two areas of importance to the Bank's function as regulator of CCPs and CSDs. The Bank is to consider the interrelated and global nature of clearing and settlement services and the potential financial stability impact of UK CCPs and CSDs on other jurisdictions. The FSM Bill also makes explicit that the Bank must have regard to ensuring that its regulation is based on financial stability risks and not on the basis of nationality or location of users of CCP or CSD services. This is considered to reflect the existing approach taken by the Bank and necessary simply to provide additional reassurance to global users of these infrastructure.

The Bank is also given a new secondary objective to facilitate innovation in the clearing and settlement services provided by CCPs and CSDs. This differs from the PRA's and FCA's new secondary objective to facilitate competition, in recognition of the unique nature of CCPs and CSDs in global financial markets. Nonetheless, it is intended to improve the quality, efficiency and economy of the services provided.

In addition to its statutory objectives, the Bank is required to have regard to similar regulatory principles to the FCA and PRA when policymaking. One additional regulatory principle is added; to facilitate fair, reasonable and equitable provision of services by CCPs and CSDs to their members. The consumer responsibility principle is also finessed to reflect the fact that specific types of financial services firms use CCP or CSD services, not retail consumers.

The FSM Bill also gives HMT the power to require the regulators (including the Bank) to "have regards" to things specified by HMT when they are making rules, and to explain how this has influenced their rules. Such "have regards" obligations remain subject to the Bank's statutory obligations, however. The purpose is to enable the government to ensure that more specific public policy priorities can be reflected in regulatory rule making, where it considers that appropriate.

HMT will also be able to place obligations on the regulators to make rules in relation to specific areas of regulation.

Additional powers

The Bank's new general rule-making power is supported by additional powers which replicate arrangements for the PRA and FCA. These include powers to take enforcement action alongside rights of appeal for the CCP or CSD, powers for the Bank to waive or modify rules and investigatory and information gathering powers.

With great power comes greater accountability?

When exercising its rule-making powers, the Bank will have to comply with various provisions of the FSMA. These include requirements relating to consultation, cost benefit analysis, explanation of the purpose of the proposed rules, compatibility with the Bank's statutory objectives, publication and notification to HMT.

That said, HMT can exempt the Bank from the requirement to conduct a consultation and a cost benefit analysis. This is so where the Bank concludes that the most appropriate course of action is to replace retained EU law with rules that are materially the same as the relevant revoked legislation.

The discretion to exempt proposals from consultation rests with HMT and the explanatory notes to the FSM Bill state that "[s]ometimes, a decision by the regulators not to make substantive changes to existing requirements… can and should be open to public consultation". There is no information on how HMT will exercise this discretion.

The government considers that the Bank already engages effectively with the CCPs and CSDs that it regulates. As such, the government does not consider a statutory panel for these firms would be proportionate or effective.

The FSM Bill does, however, introduce a requirement for the Bank to report annually on the efforts it has made to engage with industry stakeholders aside from those that it directly regulates and to give a summary of the engagements. The questions around how, who and when this engagement should take place are left to the Bank's discretion.

Following consultation in November 2021 on proposals to strengthen the engagement mechanisms between HMT and the regulators, the FSM Bill contains provisions "balancing" the greater responsibility being given to the regulators with "effective policy input from, and appropriate accountability to, government".

The regulators (including the Bank in its regulation of CCPs and CSDs) are required to respond to HMT recommendations, to keep their rules under review and to publish a statement of policy providing clarity and transparency on how and when rules are reviewed.

HMT can also require a rule review by the regulator, where it considers it to be in the public interest. Further information on the accountability of the regulators in relation to their greater powers will be discussed in a separate briefing.

Individual accountability within the FMI space

The FSM Bill introduces a Senior Manager and Certification Regime (SMCR) framework for CCPs and CSDs that is similar to the existing SMCR for banks, insurers and other authorised persons. RIEs are also within scope of the framework and the FSM Bill gives HMT the power to apply the regime to credit rating agencies. The government will be able to decide when to apply the regime to any of the entity types and to tailor the regime to each type.

When HMT applies the regime to CCPs and or CSDs, the Bank will be given new powers to implement, supervise and enforce the SMCR and conduct rules.

Like the SMCR for other regulated firms, the senior managers regime gives the regulators the power to determine where individuals who perform roles that pose a potential risk to the firm or to business or other interests in the UK, have the appropriate competence, expertise and personal characteristics to carry out their roles.

The certification regime requires firms to certify as fit and proper any individual who performs a specified function that could cause significant harm to the entity or its consumers.

Conduct rules will apply to all employees (including contractors and secondees) and set minimum, high-level requirements regarding the conduct of individuals at these systemically important entities.

The regulators will have the power to impose financial penalties, take action against misconduct and to make prohibition orders. It will be a criminal offence to perform a function in breach of a prohibition order. In certain circumstances, a private individual may also have a right of action for damages.

Other existing offences will also be extended to encompass the SMCR. This includes the offence of knowingly or recklessly provide false or misleading information to the regulator in relation to the regime.

Encouraging FMI innovation in a safe place – the FMI sandbox

The FSM Bill provides for the creation of FMI sandboxes in which HMT may make regulations which provide for the testing of FMI activities using developing technology or adopting new or different practices. An FMI sandbox is intended to create opportunities to review the existing legislative framework against new developments, whilst protecting the appropriate regulatory outcomes. HMT will be able to temporarily disapply or modify relevant legislation relating to the regulation of FMIs in the sandbox.

Although much of the discussion to date has been on the use of distributed leger technology (DLT), the FMI sandbox powers are intended to be sufficiently flexible to enable different FMI sandboxes to test different technologies and practices for different entities and activities. In practice, we anticipate much of the early focus will be similar to that which has been part of the development of the **EU DLT pilot regime**, though clearly the breadth of the UK framework is not limited in that manner.

The sandbox is intended to facilitate innovation whilst allowing HMT, regulators and industry to better understand the impact of new technologies and practices. This will help the regulators to meet their objectives and to understand what changes should be made to the legislative framework to support an effective and safe adoption of such innovation.

HMT will be able to make permanent changes to legislation on the basis of lessons learned in each FMI sandbox. HMT will consider whether further consultation is needed with industry when making legislation permanent.

CCP recovery and resolution

The FSM Bill will expand the UK's CCP recovery and resolution regime, following HMT's consultation in February 2021. The Resolution Directorate at the Bank is the UK's resolution authority and would oversee any CCP resolution. This part of the Bank is organisationally distinct from the part of the Bank responsible for the ongoing regulation and supervision of CCPs, although that part of the Bank does have oversight of a CCPs recovery and recovery planning.

The UK's current resolution regime for CCPs, contained in the Banking Act 2009, provides the Bank with a limited set of powers to transfer the property or ownership of a CCP. The expanded regime, which will replace that in the Banking Act 2009, will build on this with eight stabilisation options achieved through the exercise of three stabilisation powers.

The FSM Bill also sets out five special resolution objectives which the Bank must have regard to when using or considering using its stabilisation powers. HMT, following consultation with the Bank, PRA and FCA, will issue a code of practice which the Bank must also have regard to.

The Bank's powers will include:

- temporarily restricting or prohibiting any remuneration of equity for CCP shareholders or variable remuneration for a CCP's senior staff;
- suspending clearing members' early termination rights that arises as a result of the CCP being placed in resolution;
- suspending rights to enforce security interests;
- taking control of the CCP;
- removing or replacing directors and senior managers;
- returning the CCP to a matched book;
- providing full or partial termination of contracts;
- variation margin gains haircutting;
- writing down unsecured liabilities and/or issuing a statutory cash call on clearing members; and
- delaying enforcement of a clearing member's obligations in resolution.

Together with HMT, the Bank is also empowered to require CCPs to hold a greater amounts of their own capital for loss absorption. This will be a second tranche of "skin in the game" after the prefunded default fund.

The Bank's powers vary depending on the cause of the CCP's losses; whether as a result of a default or a non-default loss scenario.

There are also a number of safeguards, including a "no creditor worse off" safeguard which seeks to ensure that creditors of the CCP have the right to compensation if they are worse off in resolution that they would have been had the CCP simply entered insolvency.

The FSM Bill further sets out powers and requirements in relation to CCPs which are exercisable by the Bank in advance of resolution. These include removing impediments to the exercise of stabilisation powers and powers relating to information, investigation and enforcement.

The FSM Bill also prescribes the treatment and effects of third country resolution action in respect of a third-country CCP.

What should we be doing now?

1. Watch this space

Given the systemic importance of the FMI and the international standards in this area, we are unlikely to see a bonfire of regulation. Nonetheless, as with other areas, we do hope to see adequate transparency and consultation on the new framework.

Whilst the UK's CCPs and CSDs will take great interest in these parts of the FSM Bill, third country FMI and their users will no doubt pay attention too. Questions around which third country firms might be brought into scope of the Bank of England's rules might cause concern when coupled with uncertainty around what, if any, consultation there might be on the substance of the rules.

Participants of CSDs and CCPs will also be keen to understand the practical implications of this new framework on them and their access to and cost of services.

2. Prepare for the SMCR

FMI firms and their senior managers will be keen to engage in consultations around the scope of the SMCR and conduct rules.

Although it may be premature for such firms to prepare for implementation of the SMCR, it is not too soon to think ahead. Firms should consider how they are set up and run their business, in order to put themselves in the best possible position when the details of the regime are announced. Whilst the business of FMI is different to that of other PRA/FCA regulated firms, significant learning can still be taken from the implementation of SMCR in relation to those firms.

Firms should start thinking about whether roles and internal reporting lines are clearly defined and whether existing governance arrangements are clear and operating effectively.

It is also worth looking at recent pulse and annual workforce surveys to assess the culture of your firm. See how our **individual accountability experts** can help.

3. Consider how the sandbox might help you

It is clear that innovation in the post trade space is both desired and happening. Firms cannot rest on their laurels and should consider their understanding of and engagement with new technology and processes. Anything that reduces settlement times or periods of risk or creates other efficiencies in this market will be of great interest to the Bank.

4. Consider the implications of the new special resolution regime for CCPs on cleared business

The three UK CCPs will be required to prepare their recovery plan and assist the Bank in preparation of their resolution plans. They will also want to review their rulebooks.

A number of the Bank's stabilisation options could have direct consequences for clearing members. Such firms will also want to consider the implications of this expanded regime on their business, including by way of example only, any indirect clearing arrangements and internal policies and procedures.

If you have any questions about the subjects covered in this alert, please get in touch with your usual A&O contact.

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