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Regulatory Update

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1. FCA UPDATES & DEVELOPMENTS

1.1 FCA speech on international regulatory developments affecting investment management

On 5 June 2024, the FCA published a speech by Nikhil Rathi, FCA Chief Executive, delivered at the Investment Association Annual Conference. The speech covered the following points:

- key international initiatives, such as anti-dilution tools and a system-wide exploratory scenario
- global innovators, including the Digital Securities Sandbox and AI
- what investors want, including the introduction of Long Term Asset Funds (LTAFs)
- making regulation more efficient, by replacing EU legislation and publishing a discussion paper to improve the asset management regime
- how the FCA is preparing for the future, covering the FSCS annual levy.

1.2 Eighth edition of the Regulatory Initiatives Grid delayed

On 5 June 2024, the Bank of England published a notice that, following the Government announcement of the General Election on 4 July, the eighth edition of the Grid would be delayed and that members of the Financial Services Regulatory Initiatives Forum would consider when best to publish an update on the regulatory pipeline and initiatives later this year. The Forum's statement and previous editions of the Grid are on the FCA's website.

1.3 FCA postpones publication of review findings on treatment of PEPs

On 19 June 2024, the FCA published an update on its review of the treatment of Politically Exposed Persons (PEPs) by financial services firms that it launched last year.

The FCA had been on track to publish the findings from this review in line with the end of June deadline set in the Financial Services and Markets Act 2023.

However, the FCA does not think it is appropriate to publish the review during the pre-election period. It will now publish it in July once Parliament has returned.

1.4 FCA finds that Digital Engagement Practices used by trading apps can increase the trading frequency and risk taking of consumer.

On 20 June 2024, the FCA published a research note: Digital engagement practices: a trading apps experiment.

The FCA's research found that digital engagement practices (DEPs), used by trading apps, such as gamification, can increase the trading frequency and risk taking of consumers.

In an online experiment with over 9,000 consumers, the FCA tested 4 DEPs looking at their effect on trading frequency and investment risk. The DEPs looked at were:

- flashing prices

- push notifications
- trader leaderboard
- points and prize draw.

The key finding is that DEPs can lead to changes in both trading and frequency and investment risk. It also found some evidence that DEPs can have a larger effect on:

- those with lower financial literacy
- women
- participants aged between 18-34.

The FCA concluded that this suggests that firms and regulators should continue to closely scrutinise the effect of trading app design features on consumer investment decisions, especially in light of the FCA's Consumer Duty.

1.5 FCA publishes new webpage on overseas appointed representatives

On 27 June 2024, the FCA published a new webpage on overseas appointed representatives. This webpage sets out the challenges and expectations for principal firms with overseas appointed representatives (OARs).

Challenges for principals with OARs

Feedback to the FCA's consultation on improving the appointed representatives regime (PDF) showed that principals may have challenges overseeing and communicating effectively with their OARs due to:

- differences in legal, accounting and regulatory requirements for each jurisdiction
- geographical distance
- cultural and language differences.

Expectations for principals with OARs

The FCA expects monitoring and oversight of OARs to account for any extra challenges that may arise as outlined above.

Principal firms should consider whether customers dealing with an OAR will receive equivalent services, protections and outcomes as those dealing with UK-based appointed representatives (ARs).

If not, firms should make sure customers are given suitable information to alert them to any differences.

Principals must also establish on reasonable grounds, on a continuing basis, that the activities of their OARs do not result in undue risk of harm to consumers or market integrity.

Practical considerations for principals with OARs

- when completing the annual self-assessment document, firms should consider the additional risks of having OARs when assessing their controls and resources as per SUP 12.4.2(3)

- the application of the approved persons regime to OARs (including individuals within OARs performing a customer function) depends on, among other things, whether the activities are carried on from an establishment in the UK and how long individuals performing a customer function spend in the UK annually. See SUP 10A for more information
- firms must also ensure that AR agreements require their OARs to comply with relevant rules (SUP 12.5.5R and including, for example, the communication requirements in GEN 4.4.1R).

If firms cannot adequately monitor the activities of an OAR, or if it does not carry out regulated activity in the UK, they should consider terminating the agreement.

Firms can notify the FCA of any terminations (and other AR updates, including to addresses) by submitting the relevant form on Connect.

Read more about your responsibilities as a principal firm.

Preventing harm from OARs

The FCA continues to use data to inform its approach, including whether any targeted supervisory engagement with principals with OARs is needed in future.

2. PRA

2.1 Bank of England publishes scenarios for 2024 desk-based stress test for UK banks

On 27 June 2024, the Bank of England announced an exercise to test the resilience of the UK banking system to two hypothetical scenarios, which include severe but plausible combinations of adverse shocks to the UK and global economies.

- To support the Financial Policy Committee's (FPC's) and the Prudential Regulation Committee's monitoring and assessment of the resilience of the UK banking system to downside risks, the Bank of England ('the Bank') is carrying out a desk-based stress test in 2024. The exercise will not involve firm submissions of stressed projections. It will use the Bank's own estimates of the impact of the stress scenarios on the resilience of the UK banking system.
- A key benefit of a desk-based exercise is to allow for that resilience to be tested to more than one adverse macroeconomic scenario. The exercise will test the resilience of the banking system, as represented by the major UK banks and building societies that account for around 75% of the sector's lending to the UK real economy, to two hypothetical scenarios. These scenarios include severe but plausible combinations of adverse shocks to the UK and global economies.
- The scenarios are countercyclical and linked to the FPC's assessment of the underlying level of risks and vulnerabilities in the UK and global economies and financial markets.
- Both scenarios are designed to be severe and broad enough to assess the resilience of the UK banking system to a range of adverse shocks.
  - **The supply shock scenario** sees a severe, negative global aggregate supply shock from an increase in geopolitical tensions and global commodity prices and supply-chain disruptions. This leads to higher-than-expected inflation across advanced economies. High inflation is

assumed to lead to expectations of higher inflation in the future and global policymakers increase interest rates to bring inflation back to target. In this scenario, Bank Rate rises to 9% and stays there for a year.

  - **The demand shock scenario** sees a severe negative global aggregate demand shock and global recession, resulting in falling inflation. This prompts Bank Rate to fall rapidly from 5.25% to 0.1%, remaining below 0.5% for two years, to support the recovery and return inflation to target.

- In both scenarios, there is a domestic and global recession, with UK GDP falling by 5%, unemployment rising to 8.5%, and house prices falling by 28%. World GDP falls by 3%. The macroeconomic scenario results in sharp moves in other asset prices. There are assumed to be further falls in UK and global commercial real estate prices, equity prices fall, government bond term premia rise, and corporate bond spreads widen.
- The scenarios applied in the stress test are not a forecast of macroeconomic and financial conditions in the UK or abroad. The scenarios are not a set of events that are expected, or likely, to materialise. Rather, as per the scenarios used in previous exercises, they represent coherent 'tail-risk' scenarios designed to be severe but plausible and broad enough to assess the resilience of the UK banking system to a range of adverse shocks. Monetary policy responses in the scenarios do not represent a forecast of how policy would actually respond in such a scenario.
- The Bank will publish findings from the desk-based exercise at an aggregate level by the end of 2024. It will not publish results at the level of individual banks.

3. EU REGULATORY UPDATES

3.1. ECB consults on outsourcing cloud service

On 3 June 2024, the European Central Bank (ECB) issued a consultation on a new draft guide on outsourcing cloud services.

The Guide aims to clarify both the ECB's understanding of related legal requirements and its expectations for the banks it supervises. This will make supervision more consistent while helping ensure a level playing field for all banks. The Guide draws on risks and best practices observed by Joint Supervisory Teams in the context of ongoing supervision and dedicated on-site inspections.

The deadline for submitting comments was 15 July 2024.

3.2. ESMA and EBA discussion paper on call for advice on the investment firms prudential framework

On 3 June 2024, the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) issued a discussion paper on the potential review of the investment firms' prudential framework.

The discussion paper aims at gathering early stakeholder feedback to inform the response to the European Commission's call for advice (CfA). The consultation runs until 3 September 2024. To assess the impact of the possible changes discussed in the paper, the EBA also launched a data collection exercise on a voluntary basis.

The discussion paper touches upon a broad range of topics, including:

- the adequacy of the current prudential requirements
- an analysis of the existing methodology
- risks not covered by the current framework.

It also discusses the implications of the adoption of the new EU Banking package (CRD VI and CRR 3) concerning the trading book, the fundamental review of the trading book (FRTB) and credit valuation adjustments (CVA).

Furthermore, prudential consolidation and a possible extension to crowdfunding and crypto-assets service providers are also considered. In this respect, the discussion paper provides an overview of the interaction of IFD/IFR with requirements applicable to undertakings for collective investment in transferable securities (UCITS) management companies and alternative investment funds managers (AIFMs) providing MiFID services on an ancillary basis, or investment firms providing services related to crypto-assets.

The discussion paper also covers aspects related to remuneration in relation to investment firms, AIFMs and UCITS management companies, including the scope of application, remuneration policies, the requirements on variable remuneration, their oversight, disclosure and transparency. Finally, the discussion paper includes a short section on the treatment of firms currently non-prudentially regulated and active in commodity markets.

An ad-hoc data collection addressed to competent authorities, investment firms, and UCITS management companies and AIFMs has been launched in parallel to the publication of the discussion paper.

EBA and ESMA will prepare the joint EBA-ESMA Report in response to the CfA, which will include a broad assessment of the provisions of the IFR and IFD and their interaction with other regulations.

4. ESG

4.1 ESAs call for enhanced supervision and improved market practice on sustainability-related claims.

On 4 June 2024, the European Supervisory Authorities (ESAs) published their final reports on greenwashing in the financial sector.

In their respective reports the ESAs reiterate the common high-level understanding of greenwashing as a practice whereby sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial service. This practice may be misleading to consumers, investors, or other market participants. The ESAs stress once again that financial market players have a responsibility to provide sustainability information that is fair, clear, and not misleading.

ESMA final report

The supervision of sustainability-related claims has become a priority for National Competent Authorities (NCAs). NCAs and ESMA are taking steps to better monitor and detect greenwashing and to critically scrutinise sustainability-related claims in various sectors. Several Common Supervisory Actions have already been launched, with a view to ensuring effective and consistent supervision. At the same time, NCAs still face constraints on their resources, as well as on their access to expertise and to good quality data. The report recorded that:

- **NCAs** are expected to gradually deepen their critical scrutiny of sustainability-related claims. To achieve this, they are invited to continue increasing human resources and expertise, making investments in supervisory tools such as SupTech solutions and further embed greenwashing risks in their respective supervisory work programmes.
- **ESMA** will continue to support the monitoring of greenwashing risks, the deployment of SupTech tools, and capacity building. In addition, ESMA will prompt Common Supervisory Actions where needed. ESMA may produce additional guidance for market participants and supervisors in high-risk areas of greenwashing.
- The **European Commission** is invited to reinforce NCAs' and ESMA's mandates in certain areas, such as for benchmarks, and make sure all NCAs have the powers to promote retail investors' financial education. Whenever possible, the Commission should ensure the legislative framework supports NCAs' access to data.

Next steps

ESMA will continue monitoring greenwashing risks and supervisory progress, including via the ongoing Union Strategic Supervisory Priority on "ESG Disclosures".

Building on the preliminary regulatory remediation actions identified in the Progress Report, ESMA will publish an Opinion with views on how the EU regulatory framework for sustainable finance could further facilitate the investors' journey.

4.2 ESA's propose improvements to the sustainable finance disclosure regulation

On 18 June 2024, the three European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs) published a joint Opinion on the assessment of the Sustainable Finance Disclosure Regulation (SFDR). The ESAs call for a coherent sustainable finance framework that caters for both the green transition and enhanced consumer protection, taking into account the lessons learned from the functioning of the SFDR.

The ESAs focus on ways to introduce simple and clear categories for financial products. The simplifications consist of two voluntary product categories, "sustainable" and "transition", that financial market participants should use to ensure consumers understand the purpose of the products. The rules for the categories should have a clear objective and criteria to reduce greenwashing risks.

The ESAs recommend that the European Commission consider the introduction of a sustainability indicator that would grade financial products such as investment funds, life insurance and pension products.

In addition, the Opinion also covers the following areas:

- appropriate disclosures for products outside the two categories to reduce greenwashing
- improvements to the definition of sustainable investments
- simplification to the way disclosures are presented to investors
- technical suggestions including on which products should fall under the scope of SFDR and on how to improve disclosures regarding the negative impact of investments on people and the environment
- the need to conduct consumer testing before putting forward any policy proposals to review the SFDR, such as to introduce a categorisation system and/or an indicator.

4.3 NGFS issues updated guide on climate-related disclosure for central banks

On 19 June 2024, the Network for Greening the Financial System (NGFS) issued the second edition of its guide on climate-related disclosure for central banks.

The second edition builds on experience gathered by NGFS members that have already published climate-related disclosure reports. The guide includes a new chapter on metrics and targets to align the guide's structure with the four-pillar framework of the TCFD. The guide also provides additional support in disclosure of internal operations, building on research conducted by the subgroup Greening Central Banks' Own Operations within the workstream Net Zero for Central Banks.

The Guide's main objective is to offer practical support and inspiration to central banks that are taking their first steps in climate related disclosure. In addition, the NGFS hopes that it can provide insights for those that are already at an advanced state.

Additional work lies ahead in the preparation of recommendations on nature-related disclosure and transition planning as well as a broader disclosure on sustainability-related risks and opportunities. The NGFS welcomes the ongoing work of the Taskforce on Nature-related Financial Disclosures and that of the International Sustainability Standards Board to unify global sustainability reporting rules.

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If you wish to discuss how Waystone can assist you with any of the issues raised in this regulatory update, please contact us the details below:

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