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UK Financial Services Regulation – 2022 Year-End Review

Client Alert | February 2, 2023

In an unprecedented year for UK regulated firms, the UK Financial Conduct Authority ("**FCA**") has taken extensive action in advancing a number of regulatory initiatives. This client alert assesses the regulatory landscape through the perspective of four areas of increasing regulatory focus: (a) the UK future regulatory direction of travel; (b) fintech and cryptoassets; (c) environment, social and governance ("**ESG**") developments; and (d) the proposed extension the regulatory regime to non-financial services businesses.

Related People

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A. UK future regulatory direction of travel

> *"A bold collection of reforms taking forward the government's vision for an open, sustainable, and technologically advanced financial services sector that is globally competitive and acts in the interests of communities and citizens."*[1]
>
> Jeremy Hunt, Chancellor of the Exchequer, 9 December 2022, written statement to Parliament

On December 9, the Chancellor of the Exchequer announced a set of major reforms to the UK's financial services sector (dubbed the "Edinburgh Reforms"), which the government hopes will advance its vision for an open, sustainable and technologically advanced financial services sector.

The package contains 30 announcements, bringing together new and existing regulatory initiatives, and builds on the reform measures introduced through the Financial Services and Markets Bill ("**FSMB**"). We provide an overview of the reforms most relevant to our clients below.

I. Potential reform to the Senior Managers & Certification Regime

A review of the Senior Managers & Certification Regime will be conducted in Q1 2023, assessing where the regime could be reformed. This will entail a Call for Evidence collating feedback on the effectiveness, scope and proportionality of the regime as well as reviews by the FCA and PRA on the regulatory aspects of the framework.

II. Amendments to the prospectus and securitisation regimes

Several illustrative draft Statutory Instruments[2] have been published to demonstrate how the government can use the powers in the FSMB to reform the prospectus and securitisations regimes, which will help simplify the capital raising process for companies on UK markets and make the UK a more attractive destination for Initial Public Offerings.

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III. Exploring the case for a UK central bank digital currency

A consultation will be published to explore the case for a central bank digital currency and to consult on a potential design. The Bank of England is also set to release a technology Working Paper setting out cutting-edge technology considerations informing the potential build of a digital pound.

IV. Establishing a financial market infrastructure sandbox

To ensure the financial services sector is prepared to embrace and facilitate the adoption of cutting-edge technologies, the government confirmed its intention to set up a Financial Market Infrastructure Sandbox in 2023, which will enable firms to test and adopt new technologies and innovations in providing the infrastructure services that underpin markets.

V. Regulating ESG rating providers

To deliver on its commitment to align the financial services sector with Net Zero and to support the sector to unlock the necessary private financing, a consultation on bringing ESG rating providers into the regulatory perimeter will be published in Q1 2023.

VI. Reforming the Short Selling Regulation

A Call for Evidence[3] on reforming the Short Selling Regulation has been launched, seeking views on the practice of short selling and whether and how the practice should best be regulated. The review intends to ensure that the UK's approach to regulating the short selling of shares admitted to trading reflects the specificities of UK markets, continuing to facilitate the benefits of short selling, whilst also protecting market participants and supporting market integrity. Responses are requested by 5 March 2023.

VII. Repealing the regime for PRIIPs

A consultation[4] has been issued on the repeal of the regime for packaged retail and insurance-based investment products ("**PRIIPs**") and an alternative retail disclosure framework. The government notes that current rules are unnecessarily prescriptive and can present information in unhelpful or misleading ways. Under the new regime, the FCA will determine the format and presentation requirements for disclosure. Responses are requested by 5 March 2023.

VIII. Re-assessing the role of the UK regulators

On 8 December, the government issued remit letters to the FCA[5] and PRA[6] which set targeted recommendations for how the regulators should have regard to supporting the government's ambition to encourage economic growth in the interests of consumers and businesses as well as its objective to promote the international competitiveness of the UK. The remit letters align with the new secondary objectives of the regulators to promote growth and international competitiveness of the UK economy, which are being introduced through the FSMB.

IX. Removing certain reporting requirements under UK MiFID II / MiFIR

In addition to existing Wholesale Markets Review measures, Regulations[7] have been laid before Parliament on 9 December that are intended to remove certain burdensome EU requirements related to reporting rules. For example, the rules to be repealed include the MiFID II 10% depreciation reporting rule.

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B. Fintech and cryptoassets

> *"One area of global focus is crypto, both opportunities and risks – a new product, easily accessible and able to operate cross-border, raising issues of consumer protection, market integrity, data privacy and financial crime and more."*[8]
>
> Nikhil Rathi, FCA CEO, 14 July 2022, speech at Peterson Institute for International Economics

(1) Overview

Cryptoasset markets have faced a turbulent year. Regulators view the speed of growth of cryptoassets and growing interconnectedness with "traditional" finance as potentially posing a systemic risk. In response, the FCA has noted that its approach to the regulation of cryptoassets aims to "*balance innovation and competition alongside the need for orderly markets and consumer protection*".[9] Currently, the UK does not have a bespoke regulatory regime for cryptoassets. Some cryptoassets, such as security tokens, fall within existing regulatory perimeters due to their specific characteristics most cryptoassets are currently unregulated. However, as discussed below, 2022 has seen some significant developments in this regard.

(2) Developments in 2022

Cryptoassets developments in the Financial Services and Markets Bill

The FSMB is a landmark piece of legislation for the whole UK financial services industry. The FSMB was introduced into Parliament in July and it is the first major piece of post-Brexit legislation through which the UK will build the future regulatory framework in the UK, which includes the regulatory framework for cryptoassets. Amongst a multitude of other reforms, the FSMB proposes to hand power to HM Treasury to create new digital asset regulatory regimes and bring certain cryptoassets within the scope of, and modify existing regulatory frameworks. The proposals reflect the aim to be proportionate and risk based, and, as such, the UK will start by regulating a few specific cryptoassets and service providers.

The FSMB proposes to extend the existing regulatory regime to cover "*digital settlement assets*"; a new concept in UK law which encompasses stablecoins used as a means of payment, meaning that stablecoins and cryptoassets used exclusively for investment purposes are excluded from the new rules. Under the FSMB, HM Treasury is granted a sweeping range of powers to create a regulatory regime around digital settlement assets, including the power to issue "designated activity regulations".

The FSMB also allows for a payment system using digital settlement assets to be designated as a regulated payment system by HM Treasury, which will bring such payment system under the remit of the Payment Systems Regulator ("**PSR**"). The PSR will then have powers to issue directions, influence system rules, conduct investigations and so on, with the primary aim of ensuring that the relevant DSA-based payment systems are subject to appropriate economic and competition regulation.

Law Commission consultation on legal status of cryptoassets

Towards the end of the year, the Law Commission consulted on proposals for legal reform of the law relating to property as regards cryptoassets.[10] While the consultation

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concluded that English law is largely flexible enough to accommodate cryptoassets, it does propose some limited reform. For example, the consultation recommended the recognition of a distinct third category of personal property "date objects", which would encompass cryptotokens, including NFTs.

Introduction of a cryptoasset firm change in control regime

Since January 2020, exchange providers and wallet providers have been subject to registration requirements and supervision for anti-money laundering requirements. In August of this year, the FCA imposed a 25% change in control threshold on these firms, meaning that a new owner acquiring 25% or more of the shares or voting rights must be approved by the FCA as fit and proper in advance.[11]

Implementation of the "travel rule"

The UK is also implementing the travel rule in respect of any payments made in cryptoassets in the UK. The travel rule, which requires information on the source of the assets and its beneficiary to "travel" with the transaction will have a de-minimis threshold of €1,000. Cryptoasset service providers (i.e. exchange and wallet providers) are expected to have implemented their compliance solutions by September 1, 2023.

(3) What to expect in 2023

In line with the government's intention turn the UK into a "global hub for cryptoasset technology"[12], 2023 will see further developments in the sphere of cryptoasset regulations. Most notably, we will watch the implementation of the FSMB and the outcome of the consultation on establishing a UK Central Bank Digital Currency. Additionally, a Financial Market Infrastructure Sandbox in 2023. The government has also indicated that, in the near future, certain "qualifying cryptoassets" will be brought within the scope of the financial promotion restrictions. The definition of "qualifying cryptoassets" has not yet been confirmed, but it will likely include any cryptographically secured representation of value or contractual rights which is fungible and transferable.[13] On 1 February 2023, HM Treasury published a consultation on the future financial services regulatory regime for cryptoassets . A separate client alert will shortly be published on this consultation.

C. ESG developments

> *"As the world is looking to financial markets to enable the transition to a greener and more sustainable economy, international collaboration has never been more vital. As a regulator, we have been mandated by the government to help firms transition to net zero and asked to take into account Government policy in relation to energy security."*[14]
>
> Nikhil Rathi, FCA CEO, 26 April 2022, speech at City Week 2022

(1) Overview

In the last couple of years, sustainable investing and sustainable finance have come to the fore on the global stage, primarily as a result of the climate crisis and the resulting net zero commitments increasingly being given around the world. It reflects an acknowledgement of the real financial impacts of climate change and broader ESG related issues.

Globally, no financial regulator has within its core obligations the mandate to consider the environment or broader ESG issues. Regulators typically focus on: (i) investor protection;

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(ii) market integrity; and (iii) financial stability. There is increasingly a realisation on a global basis that ESG risks can challenge each of these core regulatory objectives in different ways. Therefore, in 2022, the focus on ESG has become even more intense in the UK, and we are seeing regulatory initiatives designed to mitigate these risks.

In October 2021, the UK Government set out its Roadmap to Sustainable Investing, which introduced plans for a UK equivalent to the EU Sustainable Finance Disclosure Regulation (Regulation (EU 2019/2088) (the "**EU SFDR**"). Following this, in November 2021, the FCA published a discussion paper, setting out proposals for the Sustainability Disclosure Requirements and its sustainable investment labelling scheme, each setting the foundations for the key developments in 2022.

(2) Developments in 2022

Sustainability disclosure requirements and investment labels

In October 2022, the FCA unveiled rules for sustainability disclosure requirements and investment labels (the "**SDR Consultation**").[15] The proposed regime will establish certain sustainable investment labels, supplemented by consumer-facing disclosures and detailed entity- and product-level disclosures, as well as naming and marketing rules with broader applicability, a general anti-greenwashing rule and certain obligations on distributors. The core elements of the regime are directed principally at UK asset managers managing funds marketed to retail investors in the UK, albeit the regime will still be relevant to UK alternative investment fund managers ("**AIFMs**"). FCA-regulated asset owners (such as pension and insurance funds) are not covered by the proposals but the FCA expects to extend the regime to asset owners in due course.

The proposed anti-greenwashing rule will apply to all FCA-regulated firms and the proposed distribution rules to distributors, including investment platforms and financial advisers. Non-UK AIFMs that are marketing funds in the UK via the UK's national private placement regime are not within scope of the new regime.

The FCA is proposing to introduce three sustainable investment labels ("sustainable focus", "sustainable improvers" and "sustainable impact") which distinguish between different types of sustainable product, according to the nature of the objective and the primary channel by which each can achieve or encourage positive sustainability outcomes.

The proposed disclosure requirements include consumer-facing disclosures, applying irrespective of whether a product makes use of a sustainable investment label, and detailed entity- and product-level disclosures.

The SDR Consultation aims, as far as possible, to achieve international coherence with other regimes, such as the EU SFDR and proposals by the Securities and Exchange Commission ("**SEC**") in the United States. However, whilst the FCA considered the EU SFDR and SEC proposals in building the framework of the proposed regime, the starting point for the proposed regime is different - focusing on the labelling of sustainable investment products to clamp down on greenwashing, whereas the EU SFDR and SEC proposals focus on categorising products principally to determine disclosure requirements.

FCA TCFD–aligned disclosure rules

In January 2022, the FCA introduced rules for standard listed companies and large regulated asset owners and asset managers to disclose transition plans as part of its Task Force on Climate-Related Financial Disclosures ("**TCFD**")-aligned disclosures, initially on a comply-or-explain basis. The first disclosures under these rules will be made in 2023.

(3) What to expect in 2023

The SDR Consultation closed on 25 January 2023, and the FCA expects to publish the

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final rules in a policy statement by 30 June 2023. The proposed rules will have a staggered implementation.

In 2023 we will also see the launch of a consultation on bringing ESG ratings providers into the regulatory perimeter.

D. Bringing non-financial services firms within the regulatory regime

> *"UK financial services firms are increasingly relying on third-party services to support their operations. But while these bring multiple benefits, this increasing reliance also poses systemic risks to the supervisory authorities' objectives, including UK financial stability, market integrity and consumer protection."*[16]

(1) Overview

Non-financial service firms in their interaction with the financial sector are increasingly becoming a focus of regulators. For example, according to the UK regulators, financial services firms have become increasingly reliant on a small number of cloud and other third party providers outside the financial sector for the performance of essential services. These arrangements could, in the event of failure or disruption of the relevant technology provided to multiple firms, be a source of systemic risk to the financial sector. The risk posed to financial stability by disruption at a small number of third party service providers relied upon by firms has been on the political and regulatory agenda for some time[17] and is now being addressed.

Additionally, as part building a post-Brexit regulatory framework in the UK, a designated activities regime will cover activities and market participants which do not fall within the regulatory perimeter of the Financial Services and Markets Act 2000.

Lastly, in the last year, Big Tech firms – large technology companies with established technology platforms – have become increasingly active in the financial services sphere as a result of their large user bases, ecosystems, high market shares and significant financial resources. As a result, an increased regulatory interest has started to emerge into the way in which large digital companies operate in the UK.

(2) Developments in 2022

Regulating "critical third parties" to the financial services sector

In a landmark reform, certain services provided by "critical third parties" to financial sector participants will be directly overseen by UK regulators, according to the Financial Services and Markets Bill and a discussion paper published in July.[18] The Proposals will empower HM Treasury, in consultation with the regulators, to designate third party service providers as "*critical*". Factors that will be relevant to a designation include the materiality of services provided, critical functions and certain important business services. The discussion paper sets out a framework for identifying potential critical third parties, suggesting that some cloud service providers will likely meet the designation requirements.

The regulators will be granted extensive new powers in relation to material services provided by the designated third party to financial services firms, including the imposition of duties in relation to the provision of material services and to direct a third party from taking or refraining from specific action. The regulators will also be able to appoint investigators to investigate potential breaches of relevant rules imposed by the Regulators, enter the party's premises under warrant, publicise failings and, if required, prohibit a

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critical third party from providing future services to financial services firms.

Notably, firms already subject to oversight, regulation or supervision will not be recommended for designation where their existing authorisation, supervisory or oversight arrangement allow the regulators to impose equivalent requirements on the resilience of any services they provide to other firms and financial market institutions. However, in instances where a firm meets the designation criteria and provides services to other firms that are not already subject to regulatory oversight or supervision, the proposed measures for critical third parties could apply to that firm in respect of those particular services. The proposed critical third party regime is likely going to enter into force during 2024.

Introduction of the designated activities regime

The proposed Financial Services and Markets Bill creates a Designated Activities Regime, under which the FCA will be able to make rules relating to certain designated financial services activities, however, the FCA's remit will not extend to the wider unrelated activities of any person that carries out a designated activity, meaning that FCA authorisation or the fulfilment of threshold conditions will not be required. The activities covered by the Designated Activities Regime will be those currently regulated by retained EU law, but which are unregulated under the existing Financial Services and Markets Act 2000. Examples of designated activities include entering into derivative contracts, short selling, public offerings and using or contributing to a benchmark.

Big Tech firm's entry into financial services

On 25 October 2022, the FCA published a discussion paper on the potential competition benefits and harms from Big Tech firms entering into retail financial services.[19] The discussion paper does not propose any regulatory or policy changes, but rather focuses on the impact that Big Tech can have on payments, deposit taking, consumer credit and insurance, and potential entry strategies for these firms into these financial markets as well as their potential competition implications and identifies five key themes:

- There is a potential for Big Tech firms to enhance the overall value of their ecosystems with further entry and expansion in retail financial services sectors through innovative propositions. Big Tech entry is unlikely to differentiate between financial services markets as entry into one market will create opportunities for expansion into complementary markets, with Big Tech firms' core and other activities playing a role.
- In the short term, a partnership-based model is likely to continue to be the dominant entry strategy for Big Tech firms, but in the longer term they may seek to rely less on partnerships and compete more directly with existing firms.
- Big Tech firms' entry may not be sequential or predictable. While initial forms of entry may be hard to predict, once momentum builds, significant market changes might occur quickly.
- In the short-term and possibly enduring longer, Big Tech firms' entry in financial services could benefit many consumers. These benefits could arise from Big Tech firms' own innovations as well as increasing other market participants' incentives to innovate, improve quality and reduce prices through increased competition.
- In the longer term, there is a risk that the competition benefits from Big Tech entry in financial services could be eroded if these firms can create and exploit entrenched market power, scale and size to harm healthy competition and worsen consumer outcomes.

(3) What to expect in 2023

Subject to the outcome of Parliamentary debates on the FSMB, and after having considered responses to the discussion paper which closed on 23 December 2022, the FCA and PRA plan to consult on their proposed requirements and expectations for critical third parties in mid to late 2023.

The FCA intends to publish formal policy documents for discussion and/or consultation on the Designated Activities Regime in 2023, in parallel to the parliamentary process to enact the FSMB.

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The discussion paper on Big Tech in financial services closed on 15 January 2023, following which the FCA intends to publish a Feedback Statement in the first half of 2023.

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[1] https://questions-statements.parliament.uk/written-statements/detail/2022-12-09/hcws425

[2] https://www.gov.uk/government/publications/building-a-smarter-financial-services-framework-for-the-uk

[3] https://www.gov.uk/government/consultations/short-selling-regulation-call-for-evidence

[4] https://www.gov.uk/government/consultations/priips-and-uk-retail-disclosure

[5] https://www.gov.uk/government/publications/recommendations-for-the-financial-conduct-authority-december-2022

[6] https://www.gov.uk/government/publications/recommendations-for-the-prudential-regulation-committee-december-2022

[7] https://www.legislation.gov.uk/uksi/2022/1297/pdfs/uksi_20221297_en.pdf

[8] https://www.fca.org.uk/news/speeches/how-uk-will-regulate-future

[9] https://www.fca.org.uk/publications/business-plans/2022-23

[10] https://www.lawcom.gov.uk/project/digital-assets/

[11] https://www.fca.org.uk/firms/financial-crime/cryptoassets-aml-ctf-regime

[12] https://www.gov.uk/government/news/government-sets-out-plan-to-make-uk-a-global-cryptoasset-technology-hub

[13] Click *here*.

[14] https://www.fca.org.uk/news/speeches/critical-issues-financial-regulation-fca-perspective

[15] https://www.fca.org.uk/publication/consultation/cp22-20.pdf

[16] https://www.fca.org.uk/publications/discussion-papers/dp22-3-operational-resilience-critical-third-parties-uk-financial-sector

[17] Click *here* and *here*.

[18] Click *here*.

[19] https://www.fca.org.uk/publication/discussion/dp22-5.pdf.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact the Gibson Dunn lawyer with whom you usually work, any member of

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