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UK FINANCIAL SERVICES REGULATION – 2021 YEAR-END REVIEW

To Our Clients and Friends:

Following an unprecedented year for UK regulated firms in 2020, the UK Financial Conduct Authority used 2021 to advance a number of regulatory initiatives. This client alert assesses the regulatory landscape through the lens of three notable regulatory "hot topics": environment, social and governance ("**ESG**") developments; fintech and cryptoassets; and individual accountability and conduct risks.

ESG developments

> "*ESG matters are high on the regulatory agenda. If the financial sector is going to help support the transition to a more sustainable future, market participants and financial services firms need high quality information, a well-functioning ecosystem and clear standards. And consumers need to be able to rely on firms to take ESG seriously, avoid 'greenwashing' and deliver on their ESG promises*."[1]

(1) Overview

Over the last five 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.

In 2021, in particular, the focus on ESG has become even more intense in the UK, which further cemented its ESG credentials through the hosting of the 2021 United Nations Climate Change Conference (known as COP26) in November.

(2) Developments in 2021

A number of significant steps have been taken by both the UK FCA and UK government in this regard. 2021 saw, amongst other things:

- the introduction of disclosure requirements aligned with the TCFD (or Taskforce on Climate-related Financial Disclosures) for all premium listed issuers (to be rolled out to a broader range of issuers);

- a UK FCA policy statement on enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers, with first disclosures required by 30 June 2023;
- building on such work, proposals to introduce a UK "Green Taxonomy", sustainability disclosure requirements for asset managers and FCA-regulated asset owners, as well as a comprehensive labelling system for sustainable investment products. The details of the UK Green Taxonomy and the sustainability disclosure requirements will closely track the EU's Taxonomy Regulation[2] and the Sustainable Finance Disclosure Regulation[3] ("**SFDR**") requirements; and
- in more than just a symbolic move, in mid-2021 the UK FCA welcomed its first "Director of ESG", Sacha Sadan. Mr Sadan's mandate is to embed ESG considerations across the UK FCA's functions, in a "golden thread" approach.

The focus to-date has largely been to focus on the "E" rather than the "S" or "G". For instance, the UK FCA consultation on TCFD-aligned disclosure rules for asset managers referred to above is much more geared towards climate. This is not exclusively the case, however. For example, the UK FCA sourcebook containing such rules will be entitled the "ESG" sourcebook and the UK FCA has specifically said that it "*anticipate[s] that the ESG sourcebook will expand over time to include new rules and guidance on other climate-related and wider ESG topics*"[4]. Additionally, for the purposes of the UK Green Taxonomy proposals, in order for an economic activity to qualify as being sustainable it must meet a number of criteria, including complying with minimum safeguards based on certain human rights standards.

Challenges firms face

Firms face a number of challenges including:

- operating multi-nationally and complying with different regulatory regimes;
- dealing with investor requirements; and
- supranational standards and disclosures.

It is clear that the current portfolio of proposals and initiatives is the starting place and not the finishing line.

(3) What to expect in 2022

The focus in the UK on ESG is by no means set to slow down. One such area in which there is encouragingly a lot of work being done is in attempting to bring some further clarity and coherence to ESG disclosures. On November 3, 2021, in recognition of international investors with global investment portfolios increasingly calling for high quality, transparent, reliable and comparable reporting by companies on climate and other ESG matters, the creation of a new standard setting board – the International Sustainability Standards Board – was announced. This was broadly welcomed by the industry and regulators alike. Indeed, in a speech on the same day as the announcement, the UK FCA CEO, Nikhil Rathi went so far as to refer to this as a "*game changer*", noting also that the UK FCA "*will work with IOSCO and others to promote adoption of the new Board's global baseline sustainability reporting standards*"[5].

Another area in which we may well see development is in relation to ESG data providers. As industry participants more fully integrate ESG into their activities and expand their ESG-focused product offerings, they are increasingly reliant on third-party ESG data services, as well as ESG ratings and benchmark indices. It is, therefore, increasingly important that these services are delivered in a fair, effective and transparent way. We are, therefore, likely to see proposals in relation to managing risks such as lack of transparency and manipulation coming out of supranational bodies such as IOSCO and also national legislators and regulators.

As the UK FCA explained in its ESG strategy statement[6], "*[i]n the case of ESG ratings, different methodological choices result in a low correlation between different providers' ratings. Consequently, without transparency of these methodologies, it may be difficult to interpret and compare outputs across providers, potentially leading to harms for consumers…it is important providers deliver ESG data and ratings transparently, and that they have strong governance and management of conflicts of interests. The Government is therefore considering bringing these firms into the scope of FCA authorisation and regulation*". In another example of the UK FCA demonstrating awareness that it is important to find a global solution to a global problem, it has (in parallel) contributed to the International Organization of Securities Commissions' work on ESG data and ratings.

Fintech and cryptoassets

> *"It will take a great deal of careful thought to craft a regulatory regime which will be effective in the decentralised world of digital tokens. And it's clear that legislators need to consider 3 issues: how to make it harder for digital tokens to be used for financial crime; how to support useful innovation; and the extent to which consumers should be free to buy unregulated, purely speculative tokens and to take the responsibility for their decisions to do so."(Charles Randell, Chair of the FCA and PSR, September 2021)*[7]

(1) Overview

As a general matter, over the last year or so we have seen cryptoassets explode into the mainstream. Cryptoasset firms have expanded in geographical reach and "traditional" financial institutions have increased their exposure to this asset class. FCA research indicated that 2.3 million adults in the UK hold cryptoassets, up from 1.9 million in 2020.[8] The UK looks for the most part at cryptoassets through the lens of traditional financial instruments under the Financial Services and Markets Act. Essentially, cryptoassets will fall within the regulatory perimeter where they constitute securities (e.g. shares, debentures, etc.), certain derivatives or collective investment schemes.

The FCA has issued warnings regarding companies offering cryptocurrency services in the UK without being properly registered, and not meeting the required standards under money laundering regulations. From the enforcement perspective, like elsewhere in the world it is an aggressive enforcement environment for cryptoasset firms in the UK. The FCA is very active in protecting the so-called regulatory perimeter. We have also seen the FCA (like its EU counterparts) ban the sale of crypto derivatives to retail investors.

The approach being taken in the UK by the government is risk-based and so we have not seen proposals for a bespoke regulatory regime for cryptoassets for the UK although there have been a good many initiatives, including the proposal to expand the scope of the financial promotions regime to unregulated cryptoassets and a more recent proposal to bring certain stablecoins within the regulatory perimeter.

In the UK, and elsewhere internationally, there has been a focus on tackling anti-money laundering in the cryptoassets space. The UK and EU now have cryptoasset firm registration procedures derived from the Fifth Money Laundering Directive ("**MLD5**"). The FCA has been particularly focus on undertaking a robust review of an the AML framework of firms seeking MLD5 registration.

(2) Developments in 2020

There have been a number of UK regulatory developments concerning fintech and cryptoassets in 2021.

Bringing "stable tokens" within the FCA's regulatory perimeter

In January 2021, HM Treasury published another consultation paper setting out proposals to bring "stable tokens" within the FCA's regulatory perimeter. Stable tokens are defined as those tokens that stabilise their value by referencing one or more assets, such as fiat currency or a commodity and could, therefore more reliably be used as a means of exchange or store of value. This regime would bring both.

Expanding the financial promotions regime

HM Treasury is also consulting on proposals to expand the perimeter of the financial promotion regime to bring the promotion of certain types of unregulated cryptoassets within its scope. The HM Treasury proposals identify the unregulated cryptoassets that will be covered as "controlled investments" by introducing "qualifying cryptoasset" as a new category of controlled investment. the tokens and associated activities into regulation.

Kalifa Review

In 2021, we also saw the publication of the Kalifa Review of UK Fintech (the "Review"). The Review stated that the UK has the potential to be a leading global centre for the issuance, clearing, settlement, trading and exchange of crypto and digital assets. The Review called for a bespoke regime for cryptoassets should adopt a functional and technology-neutral approach, in line with the principles of the current regulatory framework, as well as the concept of "same risk, same regulation", while being tailored to the risks arising from cryptoasset activities.

Law Commission digital assets project

The Law Commission has been asked by Government to make recommendations for reform to ensure that the law is capable of accommodating both cryptoassets and other digital assets in a way which allows the possibilities of this technology to flourish. The Law Commission published an interim update paper on its digital assets project on 24 November 2021. The Law Commission anticipates publishing its digital assets consultation paper in mid-2022.

Extension of the Temporary Registrations Regime

From a practical perspective, the FCA extended the end date of the Temporary Registrations Regime ("**TRR**") for existing cryptoasset businesses from 9 July 2021 to 31 March 2022. The TRR was established in 2020 to allow existing cryptoasset firms that applied for registration before 16 December 2020, and whose applications are still being assessed, to continue trading. The FCA noted that a significant number of businesses were not meeting the required standards under the Money Laundering Regulations. The extended date allows cryptoasset firms to continue to carry on business while the FCA continues with its assessment.

(3) What to expect in 2022

We will see the proposed changes coming in, including expansion of the scope of the financial promotions regime to include cryptoassets currently outside the regulatory perimeter and bringing certain stablecoins inside the regulatory perimeter. However, we do not consider that that will be the end of the story. We fully expect that we will continue to see new laws and regulations in the UK which will respond to the regulatory risks posed by cryptoassets. The FCA is also likely to continue to be an aggressive regulator in this space, especially in areas of perceived highest risk: anti-money laundering and defending the regulatory perimeter in order to protect investors.

Individual accountability and conduct risks

"*We want firms to be clear about what we expect from them, including from their governance and culture.*" (FCA Business plan 2021/2022)

(1) Overview

The UK regulators recognise that each firm's culture is different. However, they consider that it is the responsibility of everyone in financial services to focus on culture, and they expect senior management in firms to manage the drivers of behaviour in their firms to create and maintain cultures which reduce the potential for harm.

Firm's cultures have been a major root cause of conduct failures, and the regulator's work supporting firms in delivering real and sustainable culture transformations will help prevent harm caused by inappropriate behaviours. Conduct and culture are inextricably linked to senior management accountability. In the UK, the vast majority of regulated firms are now subject to the Senior Managers and Certification Regime.

(2) Developments in 2021

> *"The focus on points of failure not only encourages greater awareness, it also promotes better calculations of judgement"(Mark Steward, FCA Executive Director of Enforcement and Market Oversight)*[9]

Non-financial misconduct

As we noted in 2020[10], the regulatory direction of travel has been to push firms to think more broadly in terms of what types of misconduct they need to tackle with an increased focus on non-financial misconduct and how this reflects the culture of the firm.

In September 2021, the FCA banned director Jon Frensham from performing any regulated activity for non-financial misconduct. The decision was notable as the Upper Tribunal found that Frensham's conviction for child sexual offences was not sufficient on its own to justify the imposition of a prohibition, as the FCA had not established a sufficiently strong factual or legal basis linking the conviction itself Frensham's lack of personal integrity as was relevant to his specific financial services role. However, the Upper Tribunal did uphold the FCA's prohibition order on alternative, narrower grounds. In assessing whether non-financial misconduct is relevant to an assessment of fitness and propriety, the FCA will need to establish that this has an impact on and is relevant to its standards and statutory objectives.

Diversity and inclusion

> "We will increasingly be asking tough questions firms about representation across grades and whether their culture is open and inclusive and provides a safe space for colleagues at all levels of the organisation" (Nikhil Rathi, FCA CEO, March 2021)[11]

The FCA has previously developed its "5 conduct questions"[12] expressly to help firms implement more effective change programmes as well as helping the FCA to interrogate progress. The 5 conduct questions are addressed to firms and require self-reflective answers. The FCA has expressly noted that it is considering adding a sixth question in its future work which will interrogate firms on diversity and inclusion, another telling indicator of culture. The FCA's Business plan stated that the FCA takes diversity and inclusion seriously and expects regulated firms and market participants to do the same.

In July 2021, the Prudential Regulation Authority, the Bank of England and the FCA issued a joint discussion paper to engage financial firms and other stakeholders in a discussion on how to accelerate the pace of meaningful change on diversity and inclusion in the sector. The discussion paper contains a number of potential policy issues including: (1) setting targets for board composition and succession planning; (2) extending diversity and inclusions into the Senior Managers and Certification Regime; (3) linking diversity and inclusion progress to remuneration; (4) setting targets for senior management and employees more broadly; and (5) the introduction of disclosures relating to diversity and inclusion. The discussion paper also raised the issue of extending guidance on "non-financial misconduct" to make it clear that this concept includes sexual harassment, bullying and discrimination based on someone's protected (or otherwise) characteristics. Taking into account feedback on the discussion paper, the PRA and FCA intend to consult on more detailed proposals in Q1 2022 followed by a policy statement in Q3 2022.

(3) What to expect in 2022

We expect the UK regulators to continue their focus on individual accountability and conduct risks in 2022.

Whilst this will be more of a progression on previous years than a new development we expect the UK regulators to really focus on how conduct and culture are reflected in the new ESG products being developed, and in the new fintech firms and products coming to prominence.

Firms can expect to be challenged on whether their ESG products really have good consumer outcomes at their heart. Regulators are likely to really test governance systems to ensure firms can demonstrate commitment to products delivering on descriptions.

Similarly, firms involved in fintech or digital assets can expect to be targeted for supervisory or thematic visits as Regulators look to test whether the culture of firms is in line with regulatory expectations, and whether systems and controls offer enough comfort that consumers and the financial system as a whole will be adequately protected as new and innovative products are launched.

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[1] https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment

[3] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

[4] FCA CP21/17: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers (June 2021), paragraph 1.5

[5] https://www.fca.org.uk/news/speeches/strategy-positive-sustainable-change

[6] https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities

[7] https://www.fca.org.uk/news/speeches/risks-token-regulation

[8] https://www.fca.org.uk/publications/research/research-note-cryptoasset-consumer-research-2021

[9] https://www.fca.org.uk/news/speeches/compliance-culture-and-evolving-regulatory-expectations-mark-steward

[10] https://www.gibsondunn.com/the-challenge-of-addressing-non-financial-misconduct-in-uk-regulated-firms/

[11] https://www.fca.org.uk/news/speeches/why-diversity-and-inclusion-are-regulatory-issues

[12] https://www.fca.org.uk/firms/5-conduct-questions-programme

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 Gibson Dunn's Global Financial Regulatory team, or the following authors in London:

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