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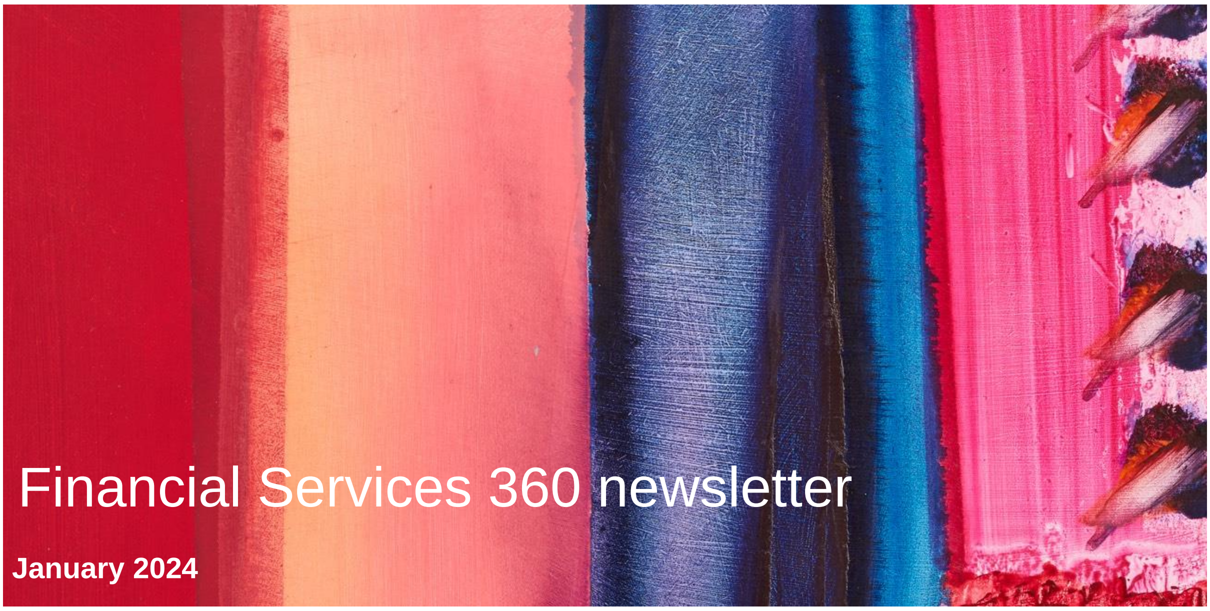

Financial Services 360 newsletter

January 2024

Welcome to our Financial Services 360. This provides concise updates on some of the key UK legal and regulatory matters from each quarter relevant to UK financial services firms, including UK asset managers, private banks and others.

In this edition for Q4 2023, we cover a variety of topics split into four sections:

- **General regulatory updates**: this includes topics likely to be relevant to a wide range of UK financial services firms, including an enforcement and EU financial services update.
- **Funds and asset managers**: this includes topics relevant to funds.
- **ESG update**: this includes regulatory developments in ESG relevant to financial services firms.
- **Payments**: this includes regulatory developments relevant to banks and payments firms.

If you have any questions on any of the topics covered please do not hesitate to contact a member of the Farrer & Co Financial Services team.

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General regulatory updates

Update on the Consumer Duty

The implementation and embedding of the Consumer Duty continues to be a regulatory priority for the FCA, and we anticipate further supervisory action and robust messaging this year, especially in the run up to the 31 July deadline for closed products and board reports. We have summarised below some of the key FCA publications over the last quarter relating to the Consumer Duty.

Consumer Duty: Speech by Nisha Arora

In November, the FCA reminded firms that the Consumer Duty was "not once and done". In a speech Nisha Arora, Director of cross-cutting policy and strategy, noted:

- Firms need to make sure they are learning and improving continuously, and must be able to evidence this in their annual board report.
- The FCA is continuing its work across all sectors to test firms' implementation and will share good practice. Some of the good practice they have already seen includes:
  - Firms simplifying language in customer communications and introducing more accessible formats;
  - Firms being more upfront about exclusions; and
  - Firms reviewing their fees with fair value in mind.
- Firms need to start considering their annual board report (an assessment of whether they are delivering good outcomes for their customers) which is due by 31 July 2024. It should include the results of their monitoring of whether their products and services are delivering expected outcomes in line with the CD. The report also needs to include actions to address any identified risks and/or poor outcomes.

Consumer Duty: Dear CEO letter to wealth management and stockbroking firms

On 8 November the FCA published a "Dear CEO" letter to wealth management and stockbroking firms, setting out its expectations for the sector, in particular relating to Financial Crime and the Consumer Duty.

It set out its expectations for the application of the Consumer Duty as follows:

Products & Services and Consumer Understanding

The FCA had seen failings with regards to these outcomes, and expected firms to:

- have a clear focus of the needs and objectives of their target market;
- ensure that their products and services remain aligned to their consumer's needs, risk profile and circumstances;
- reassess the vulnerability status of their consumers based on the FCA vulnerability guidance;
- ensure that their consumers fully understood all aspects of their investment products and services, and that they did not exploit limited understanding;
- not uprate consumers from retail to professional unless this change is supported by robust systems and controls, given the loss of protections;
- fully justify any complex and/or unregulated investments offered, with a clear view of the suitability or appropriateness for the consumer; and
- ensure their consumers understand any limitations to the Financial Ombudsman /FSCS consumer protection status and associated risks of those investments.

Price and Value

The FCA also had concerns relating to this outcome:

- They continued to see firms charging for services which are not delivered (such as ongoing advice), overtrading on portfolios to generate high transaction fees and providing a product or service which does not align with the needs of consumers (such as an expensive discretionary offering for a low-risk consumer).
- They were also concerned that firms are not consistently providing clear disclosures on their fees or charging structures. As a result, consumers can be unaware of high fees that significantly reduce their investment returns. In particular, they had seen firms charge high average fees and charge particular individuals very high fees. The FCA will

be challenging firms to justify such high charges.

- The FCA also criticised firms for not passing on fair interest on client money balances, despite interest rates having risen. In some instances, they also charge a fee for holding these funds which can further erode value and returns. This was an issue for other types of firms and is clearly a key concern for the FCA: see further below.

- It is also often unclear that consumers are being rewarded fairly when they are exposed to risk, for example, they saw firms not providing a fair share of revenue from securities lending, despite exposing consumers to risks.

The FCA expects firms to change these practices if they exist and to:

- regularly assess the overall cost and value for money of their products and services; and

- make changes when poor value is identified.

Finally, the FCA reiterated that its supervision is becoming “more assertive, intrusive, proactive and data driven.”

Consumer Duty: Dear CEO letter to investment platforms and SIPP operators

On 12 December the FCA sent a “Dear CEO” letter to investment platforms and Self-Invested Personal Pensions (SIPP) operators regarding interest on cash balances. The FCA is concerned that some firms are not complying with the Consumer Duty in the way in which they retain interest on customer cash balances. They have asked firms in scope to take action by **29 February 2024**.

The FCA reviewed 42 firms which they found collectively had earned £74.3m in one month from retaining interest from customer cash balances. Most firms retained at least some of the interest they earned on customer cash balances, and some also charged a fee on top (known as “double dipping”).

The FCA is concerned that these practices are in breach of the Consumer Duty, not only in relation to fair value, but also other outcomes and cross cutting rules, including relating to consumer understanding and the requirement to act in good faith.

Firms in scope will need to review their practices and provide certain information to the FCA. They will also need to take steps including:

- confirming that they have revisited their fair value assessments in line with PRIN 2A.4
- stopping double dipping
- providing the FCA with evidence of improvements in all their customer disclosures relating to the retention of cash interest, including in their terms and conditions.

Information must be provided by 31 January 2024, and changes made by 29 February 2024.

The FCA noted that other consumer investment firms with comparable business models, holding uninvested cash belonging to retail customers, should consider the FCA's expectations and take appropriate action.

Consumer Duty: Retail Banking multi-firm work

On 14 December the FCA published the findings of its retail banking Consumer Duty multi-firm work, in which they reviewed the implementation of the Consumer Duty by a group of banks, building societies and mortgage providers. They conducted a desk-based review of 70 product journeys across 47 firms, as well as reviewing actions that firms were taking to improve customer journeys, products or services.

The FCA has set out some helpful examples of good practice from its review:

- Completing frameworks that outlined the end-to-end customer journey across products and services, starting from the inception of the product to the post sale support for customers;
- Use of a range of data points, rather than relying on a single source of insight in their review;
- When reviewing customer understanding, identifying the area responsible for the communication, identified key communications or prompts customers used in decision-making and used a range of testing (controlled trials, experiments, surveys, interviews and focus groups).

The FCA considers these examples may be of use for firms, both in their ongoing monitoring work and also in preparing for the application of the Consumer Duty to closed products in July.

Advice Guidance Boundary review

On 8 December the Treasury and FCA published DP 23/5 on the Advice Guidance Boundary Review, which sets out its proposals for closing the advice gap. The Review's aim is to design a regulatory system where commercially viable, high-quality models of support can emerge so consumers can access support through regulated channels. The review notes that firms will need to manage rather eliminate risk.

It is a strong shared priority for the Government and FCA to address the current "advice gap", where only a very small percentage of consumers take advice and financial advice continues to be the preserve of those with greater assets.

The Review sets out three high-level proposals:

1. Further clarifying the boundary: providing FCA-authorised firms with greater certainty via guidance that they can give more support to consumers without providing a personal recommendation. This might take the form of amendments to PERG.

2. Targeted support: this would constitute a new regulatory framework, enabling firms (particularly non-investment advice firms such as retail banks and insurance firms) to broaden the support they can provide to consumers. Under this proposal, consumers would provide limited information which would enable them to be placed in a target market, for which the firm would then provide a suggested course of action. The support would not amount to a personal recommendation and could be provided without explicit charges.

3. Simplified advice: this is an amended version of the core investment advice regime on which the FCA consulted last year, with a higher financial limit (of £85,000) and greater range of products. It is aimed at enabling firms to provide support on a one-off basis to consumers who want a personal recommendation for a particular need, but for whom holistic advice would not be cost-effective.

Consumer Composite Investments

Introduction

On 22 November the Treasury published a draft SI and policy note on the new retail disclosure framework for Consumer Composite Investments, which will replace the retained EU law Packaged Retail and Insurance-based Investment Products Regulation (**PRIIPs**). It will be delivered through the new Designated Activities Regime (**DAR**).

The policy note considers the current regime to be overly burdensome and prescriptive. The new CCI regime will, among other things, provide the FCA with powers to make rules relating to CCIs, and allow the revamped Key Investor Information Document to be used for UCITS as well as CCIs.

The Designated Activities Regime

The Designated Activities Regime was introduced in FSMA 2023, and is part of the Government's Smarter Regulatory Framework. The DAR SI, which is intended to regulate all designated activities, has not yet been published. It will enable the regulation of activities where it is not proportionate to require those carrying out the activities to become authorised persons. The FCA will also need powers to supervise, investigate, and enforce rules in relation to these activities. The government is aiming to consolidate cross-cutting supervisory, investigatory, and enforcement powers in a single place, to reduce the complexity for firms which perform more than one designated activity. As with the Regulated Activities Order, the DAR SI will be updated over time, as activities move in or out of scope.

What does the CCI SI do?

- The draft SI replaces the PRIIPs Regulation with an overarching legislative framework, with firm-facing retail disclosure requirements being replaced with rules set by the FCA.

- The new retail disclosure framework for CCIs will be proportionate and tailored to UK markets, balancing support for UK businesses with ensuring retail investors receive appropriate disclosure to make informed investment decisions.

- UCITS, which are currently exempted from producing the PRIIPs KID, are being brought into scope of the new UK regime. This will ensure disclosure is aligned across similar products.

- The SI provides the FCA with rule-making powers in relation to all firms providing CCIs to UK retail investors. These additional powers will extend to both domestic and overseas unauthorised firms, and will apply to all funds marketed to UK retail investors, including UK authorised funds and recognised overseas funds.

- The SI maintains the temporary exemption which allows UCITS and overseas recognised funds to continue to provide the UCITS KIID until 31 December 2026.

The Government will need to lay the SI, which will come into force at the same time as the new FCA rules.

Cash savings market review

As set out above, the FCA is concerned about whether firms have been passing on the rise in interest rates to consumers with cash balances. On 6 December 2023, the FCA published an update on the cash savings market. In July it had published a review, setting out an action plan for banks and building societies. The FCA also committed to monitoring firm and market statistics. Their findings so far are as follows:

- There has been progress in the speed and size of interest rate changes for savers and improvements in cash ISA transfer performance across the market.
- Firms have, on average, increased rates by more than the value of the August base rate across all types of account.
- Savers are moving deposits out of easy access accounts and into higher paying fixed-term and notice accounts.

The FCA will continue to monitor firms' approaches to providing fair value for on-sale and off-sale savings products and to progress the rest of its action plan.

Change in control: UK regulators consult on replacing European guidelines

The UK regulators have historically partially complied with the Joint European Supervisory Authorities Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector (the **3L3 Guidelines**) when assessing change in control applications in respect of UK authorised entities.

In late November, the PRA and FCA (**the regulators**) published CP25/23 which proposes to replace the 3L3 Guidelines with a new PRA Supervisory Statement and FCA guidance. The PRA's new Supervisory Statement would also incorporate their current Supervisory

Statement (SS33/15) on the aggregation of holdings of the prudential assessment of controllers.

As the regulators accept, the proposed guidance does largely replicate the 3L3 Guidelines. However, there are a few key points which may have an impact on the change in control applications going forward:

- "Significant influence": the regulators' new list of factors to consider when assessing whether a person is exercising "significant influence" over the management of an authorised firm (and hence may be a controller) differs from that in the 3L3 Guidelines. In particular, the UK regulators have indicated that being a member of the board of a parent of the authorised firm may indicate that significant influence is being exercised, as may the existence of veto rights over material matters in relation to the authorised firm.

- Additional information required by the regulators: the regulators have outlined several circumstances in which they would expect to require additional information, including where the proposed change in control is "transformative": ie where the proposed acquisition is expected to lead to a material change in the authorised firm's business plan, governance or capital / liquidity position. For alternative fund managers, the regulators have noted that they will require significant additional information where "private equity or hedge fund ownership" is at 20 per cent or more.

The consultation closes on Friday 23 February 2024. Nonetheless, firms considering possible acquisitions in the UK financial services market should consider now how the regulators' amended guidance may have an impact on those planned acquisitions.

AI and Machine Learning Feedback Statement

Background

In October 2023 the Bank of England and FCA (**the supervisory authorities**) published a joint feedback statement summarising responses to their joint 2022 Discussion Paper on Artificial Intelligence and Machine Learning. The DP had sought feedback on the potential benefits, risks, and harms related to the use of AI in financial services and how regulatory clarifications, or new policy, could best support further safe AI adoption. The statement does not include policy proposals, nor does it indicate how the supervisory authorities are considering implementing current or future regulatory proposals on this topic.

Respondents made the following comments:

- Consumer harm and discrimination could result from data bias in AI models, and an unavailability of key data, market integrity/stability could be compromised by AI-induced firm failures, market manipulation, deepfakes and misinformation.
- Firms may have insufficient control over identifying these, or other, AI risks, due to the complexity and opaqueness of AI models. The need for risk mitigation may result in a greater dependency on tech firms.
- Most respondents thought existing governance structures in firms were sufficient or being adapted to address AI risks.
- A regulatory definition of AI underpinning supervisory bodies' rulebooks would not be helpful, and risked becoming quickly outdated. The preference is for a tech-neutral, principles-based or risk-based approach to regulation.
- Greater intra/international harmonisation in AI regulation would be welcome. Several respondents referred to the risk-categorisation system in the proposed EU AI Act as a key example.
- Consumer protection should be the core focus of AI regulation and supervision.

Enforcement Update

FCA censures London Capital & Finance plc

In October, the FCA censured London Capital & Finance (LCF) for its unfair and misleading financial promotions of minibonds. The FCA's investigation into the failure of LCF is part of various regulatory and administrative interventions, including the Gloster report and an ongoing investigation into potential fraud by the Serious Fraud Office.

The FCA found that the promotions presented a misleading picture of the minibonds and made them appear a far more attractive investment than they were. For example, the minibonds were showcased on seemingly independent comparison websites next to safer investments. This had the effect of enticing retail investors into investing in LCF's high-risk products. They were also advertised as ISA-compatible even though this was not the case.

As LCF is insolvent and in administration, the FCA has not imposed a financial penalty.

Wirex Limited

The FCA has accepted an undertaking from Wirex, relating to potentially unclear and unfair terms in its e-money contract. Under the terms of the contract, the circumstances in which Wirex was liable to pay compensation was unclear and the amount of compensation payable by Wirex was limited.

Wirex Limited has agreed to remove the terms identified by the FCA from its e-money contracts with consumers from 1 January 2024, and will not use the terms in its future contracts with consumers. Wirex has also confirmed that it has not relied on the relevant terms in an unfair way in practice.

FCA fines ADM Investor Services International Limited

In October, the FCA fined ADM Investor Services International (ADMISI) £6,470,600 for inadequate anti-money laundering (AML) systems and controls.

In 2014, the FCA raised concerns with ADMISI about the inadequacy of its AML systems and controls. ADMISI failed to make sufficient improvements and in 2016 agreed to make significant changes under a Voluntary Requirement. Following the implementation of various remedial actions, the requirements were lifted in 2018.

ADMISI's agreement to accept the FCA's findings meant it qualified for a 30 per cent settlement discount. Otherwise, the FCA would have imposed a financial penalty of £9,243,738.

EU Measures

AIFMD II

On 10 November 2023 the Council of the EU published the final text of the amendments to the Alternative investment Fund Managers Directive (**AIFMD**).

The changes introduce a new regime for loan originating AIFs, additional reporting and disclosure requirements for AIFMs, amended delegation and substance requirements, new rules for the fair treatment of investors and undue costs, and an updated conflicts of interest provision.

The directive also makes a number of parallel amendments to the Undertakings for Collective Investment in Transferable Securities Directive (**UCITS**) with the aim of harmonising the rules on delegations, reporting and liquidity management under the AIFMD and the UCITS frameworks.

Once the final text of the directive is formally adopted by the European Parliament, member states will have two years to incorporate the changes into their domestic legislation.

Distance Marketing of Financial Services Contracts

On the 22 November 2023 the European Council adopted Directive (EU) 2023/2673 which concerns financial services contracts concluded at a distance.

The new directive revises the current legal framework by repealing the existing Distance Marketing Directive (Directive 2002/65/EC), while including new and updated rules regarding financial services contracts concluded at a distance in a new chapter of the Consumer Rights Directive (Directive 2011/83/EU), which protects consumers engaging in all types of commercial practices.

The new directive is aimed at simplifying existing legislation, increasing consumer protection, and creating a level playing field for financial services concluded online, via telephone or through other forms of remote marketing.

Consumer Credit Directive

In October 2023, Directive (EU) 2023/2225 of the European Parliament and of the Council (the Second Consumer Credit Directive, **CCD2**), was published. This directive replaced the Consumer Credit Directive (Directive 2008/48/EC, **CCD1**).

CCD2 introduces new rules with an extended scope of application and number of changes which are intended to address digitalisation and other technological developments which have significantly changed the consumer credit market. For example, CCD2 explicitly applies to “buy now pay later” services and the operators of crowdfunding platforms and now applies to credit arrangements of up to €100,000.

The Markets in Crypto-Assets Regulations (MiCAR) 2023/4

The Markets in Crypto Assets Regulation (**MiCAR**) entered into force on 29 June 2023 and will apply as of 30 December 2024. It provides a new regulatory framework for cryptoassets in the EU, aiming to protect investors and consumers, ensuring stability of the cryptoasset market, which in turn, will increase its accessibility.

MiCAR will apply to all individuals within the EU involved in the provision and issuance of cryptoassets, cryptoasset services, or those who service EU clients providing such services. This includes the operation of cryptoasset trading platforms.

MiCAR distinguishes three types of cryptoassets:

- Asset-referenced token (ARTs), which is a type of cryptoasset that is not an electronic money token and that purports to maintain a stable value by referenced another value or right or a combination thereof, including one or more official currencies.

- Electronic money token (EMTs), which is a type of cryptoasset that purports to maintain a stable value by referencing to the value of one official currency.

- Utility token, which is a type of cryptoasset which is only intended to provide access to a good or service supplied by its issuer.

What does MiCAR propose to do?

MiCAR aims to establish safeguards for consumers, whilst addressing potential risks to financial stability through the following measures:

- Introducing regulatory rules for providers and issuers of cryptoassets, encompassing entities involved in operating operate cryptoasset trading platforms, cryptoasset exchanges, providing advice on cryptoassets products, custody and transfer of crypto assets, as well as those executing orders for cryptoassets on behalf of clients.
- Establishing regulatory rules for cryptocurrencies that are benchmarked against a commodity or stablecoin, such as e-money and stablecoins.
- Creating an authorisation framework for providers and issuers of cryptoassets.
- Providing regulatory certainty for cryptoassets not currently covered by existing EU legislation.

Funds and asset managers

“Polluter pays”: proposed changes to the prudential regime for Personal Investment Firms

The FCA has become increasingly concerned that a minority of "Personal Investment Firms" (PIFs) – firms that mainly provide advice and arrange deals in retail investment and pension products – have been causing significant consumer harm. With a number of these firms leaving the market, this has led to the FSCS paying out around £757m to claimants between 2016 and 2022. The FCA therefore wants those PIFs which cause harm to bear any liability arising from their actions – in other words, the "polluter pays".

In late November, the FCA therefore published CP23/24 in which it proposed to amend the prudential rules applicable to PIFs (IPRU-INV 13) by requiring PIFs to:

- quantify their potential redress liabilities which will involve:
    - PIFs reasonably estimating the funds needed to provide redress to each customer if liabilities crystallised (which may be reduced by the cover which professional indemnity insurance is likely to provide);
    - PIFs aggregating their per customer redress amounts; and
    - PIFs then applying a "probability factor" to their aggregate potential redress liabilities. The minimum probability factor is 28 per cent but a PIF must apply a higher probability factor where it considers that a 28 per cent probability factor discounts their total potential redress liabilities "by more than what is reasonable";
- once a PIF has calculated its potential redress liabilities, it must deduct these liabilities from the capital resources it maintains; and
- if the deduction noted above results in the PIF breaching its capital resources requirement, it will be subject to an "asset retention requirement". If subject to this requirement, PIFs must not deal with any of their assets (in the UK or overseas) unless the relevant transaction occurs in the "ordinary course of business". As part of this, firms will, for instance, need FCA consent to pay dividends or LLP members' drawings.

The FCA has also included a "Discussion Chapter" in CP23/24 in which it has floated some wider changes to the prudential regime for PIFs. Notably, the FCA has sought views on whether PIFs ought to be subject to a liquidity requirement and whether specific processes for the assessment of risks/capital needs (similar to the internal capital adequacy and risk assessment for MIFIDPRU firms) ought to be introduced for PIFs.

The consultation is open for an extended period of 16 weeks and closes on 20 March 2024. The FCA expects to publish a response to feedback in H2 2024 with rules to come into force in H1 2025.

In conjunction with CP23/24, the FCA has also published a letter addressed to the CEOs of PIFs. In this letter, the FCA warns that PIFs must not seek to avoid their potential redress liabilities. Accordingly, the FCA will therefore carefully scrutinise any authorisation and cancellation applications during the CP23/24 consultation period to ensure that firms are not attempting to avoid these potential redress liabilities.

Money Market Funds

On 6 December the FCA published CP 23/28 on updating the regime for Money Market Funds (**MMFs**). The Treasury also published a draft SI for consultation and accompanying policy note, which will replace the UK Money Market Fund Regulation with a new framework which they consider to be better suited to the needs of the UK market. The proposals are also intended to enhance the resilience of MMFs, addressing vulnerabilities seen during the 2020 “dash for cash” and other times of financial stress. The FCA consultation sets out the accompanying FCA Handbook rules to replace those that will be deleted from legislation.

At the same time, the Treasury and FCA published documents relating to the new Overseas Funds Regime, which you can read about in our article here.

The FCA notes that around 90 per cent of total assets under management in sterling MMFs are domiciled outside the UK. The Treasury rules include the new Overseas MMF Regime which will enable approved MMFs to market into the UK, provided they apply to the FCA for recognition either under s. 271A or 272 of FSMA, or notify the FCA under the National Private Placement Regime.

Proposed changes include the following:

- A significant increase in the minimum liquid asset requirement for all MMFs

- The removal of the regulatory link between liquidity levels in MMFs that have the ability to offer subscriptions and redemptions at a constant Net Asset Value (NAV) (so-called "stable NAV MMFs") and the need for the manager to consider or impose tools such as liquidity fees or redemption gates. This is known as "delinking" and is intended to make those MMFs' liquidity buffers more usable.

- Enhanced KYC requirements.
- Enhanced stress testing for stable NAV MMFs.
- Enhanced operational resilience for stable NAV MMFs.

The consultation closes on 8 March 2024.

Authorised Fund Manager multi-firm review

On 16 November, the FCA published the results of its review on Authorised Fund Managers' implementation of the "Guiding Principles" for ESG and sustainable investment funds. The Principles had been laid out in the FCA's Dear AFM Chair letter of July 2021, and sought to promote consumer trust by ensuring firms met high standards for the design, delivery, and disclosure of funds' ESG and sustainability characteristics.

The review was based on the responses of 12 AFMs of varying sizes, and came ahead of the FCA's policy statement on Sustainability Disclosure Requirements setting out the finalised rules (which you can read more about in our article here).

The FCA found that while there was evidence of good practice in the design and delivery of ESG/sustainable investments, the disclosure principle had not been embedded sufficiently in some cases.

Core areas of poor practice identified were:

- The use of sustainability-related terms in the name of a fund, despite there being no explicit ESG or sustainability objective.
- Fund holdings which were inconsistent with the fund's ESG or sustainability objectives.
- Insufficient stewardship approaches. Some AFMs should have done more through their firm and fund level disclosures to explain how their approach supported the delivery of the fund's sustainability objectives and how they measure delivery of stewardship outcomes.

- ESG and sustainability information which was not made accessible, clearly presented, or explained and contextualised in disclosures.

The FCA identified and suggested examples of good practice across the design, delivery, and disclosure principles, such as the use of ESG/sustainability scoring systems and benchmarks, and asset selection due diligence processes embedded within AFMs' investment processes.

Updating and improving the UK asset management regime

In December 2023, the FCA published its QCP 42 (CP 23/25) which contained, among other things, some changes pursuant to its discussion paper earlier this year (DP 23/2) on updating and improving the UK asset management regime.

The proposed changes include the following:

- Amending COLL 4.4 to enable the option of electronic participation at general meetings, where the instrument constituting the fund permits this. This will allow a meeting to be fully remote, in person, or hybrid. A unitholder who participates remotely should be entitled to the same rights of participation as if they were physically present.
- Amending COLL 4.4.12R to clarify that service on any one of joint unitholders is service on the other joint holders.
- Enabling Shariah compliant funds to allow income purification (a sum paid to a registered charity) as a standard element of COLL rules.
- Clarifying the allocation of payment rules.
- Broadening the range of investments under the Qualified Investor Scheme rules.

Fund Tokenisation

On 24 November 2023 the industry-led Technology Working Group of the Government's Asset Management Taskforce released an interim report, outlining a strategic blueprint for the implementation of fund tokenisation in the UK.

Tokenisation is the process of recording an asset on distributed ledger technology (**DLT**). An investor's share in a fund is turned into a digital token that is recorded on a smart contractenabled blockchain, a highly programmable, automated and cryptographically secure database shared between parties. A range of information can in theory be coded into the token, such as details of its ownership and the value of the token's reference assets.

With various potential benefits of fund tokenisation such as increased operational efficiency, data integrity, access to a broader investment base, cost efficiency and transparency, traditional fund architecture is set to change at an increasing pace. In response to this, regulatory authorities such as the FCA have begun to explore developments in this area. The FCA have stated that the overall objective behind the tokenisation of fund interests and the associated technology is to "improve efficiency, transparency, and the international competitiveness of the UK's investment sector."

The report set out a "staged approach" to fund tokenisation. Stage one consists of establishing regulatory certainty for UK fund tokenisation, fostering distributed ledger technology (**DLT**) innovation across the UK investment management industry and developing an anti-money laundering registration process. Future stages will focus on developments in the availability of digital money and the use of a digital identity.

The Treasury and FCA are observers on the Working Group. In October 2023 the FCA joined Project Guardian, a regulatory project initiated by the Monetary Authority of Singapore in May 2022, to work with global partners and the financial industry to share knowledge and examine the benefits, regulatory challenges, and commercial use cases of asset and fund tokenisation.

ESG update

TCFD 2023 Status Report

On 12 October the Task Force on Climate-related Financial Disclosures ("TCFD") published its 2023 status report on the current state of climate-related disclosure practices. They used AI to review public reports of over 1,350 large companies, the global top 50 asset managers, and the global top 50 asset owners. The report is the sixth and final to be produced by the TCFD, with the ISSB assuming responsibility for monitoring climate disclosures from 2024.

The report found that TCFD-aligned disclosures continue to grow. 58 per cent of companies were found to be disclosing in line with at least five of the 11 TCFD-recommended disclosures in the 2022 fiscal year, up from 18 per cent in 2020 (though only 4 per cent satisfied all 11). For the top 50 asset managers and asset owners, the figure was nearly 70 per cent and 36 per cent respectively.

However, the report called for further progress. It proposed that companies should do more to incorporate climate-related information into their financial filings, not merely their annual reports (which were four times more likely to contain the relevant disclosures). It also called for companies to be more transparent to stakeholders about the actual and potential financial impact of climate-related issues, and the uncertainties in estimating such impact.

FSB 2023 Progress Report on Climate-Related Disclosures

On 12 October 2023, the Financial Stability Board (FSB) published its Progress Report on Climate-Related Disclosures. It highlighted that:

- The International Sustainability Board's (ISSB) inaugural sustainability standards, IFRS S1 and S2, will serve as a global framework for sustainability disclosures. The IFRS standards were published in June 2023 and effectively replace the TCFD-aligned disclosures for reporting periods beginning on or after January 1 2024 (see note on the TCFD Status Report above)

- Several FSB member jurisdictions have indicated that they intend to adopt or endorse the ISSB standards, though some have noted interoperability challenges between the standards and local jurisdictional frameworks (such as definitional inconsistencies). Progress is being made to improve interoperability, particularly with respect to EU jurisdictional standards.

- The International Auditing and Assurance Standards Board (IAASB) and International Ethics Standards Board for Accountants (IESBA) have made encouraging progress in the development of a comprehensive system of global assurance, ethics and independence standards for sustainability disclosures, which could serve to deter greenwashing.

- FSB jurisdictions are all taking action on climate disclosures, with each jurisdiction having requirements, guidance, or expectations in respect of climate-elated disclosures in place, or having taken steps to do so.

ESMA report on Disclosures of Climate-Related Matters in Financial Statements

On 25 October, the European Securities and Markets Authority (ESMA) published a report on disclosures of climate related matters in financial statements.

The report set out possible (but not exhaustive) ways in which issuers may make such disclosures by providing real life examples from selected issuers. The report urged issuers to consider these examples in preparing and auditing 2023 annual financial statements in order to enable investors to better make informed decisions, prevent greenwashing, and protect investors.

The report is to be considered alongside the underlying International Financial Reporting Standards requirements (IFRS). While ESMA considers that the IFRS provide a sufficient basis for climate related reporting in financial statements, ESMA's report acts as an illustrative tool to help improve issuers' practices.

The examples are overlaid with commentary and key areas of continued focus on core areas such as impairment of non-financial assets, major sources of estimation uncertainty and accounting policies.

Update to ESMA's proposed Guidelines on ESG and sustainability-related terms in fund names

On 14 December, the European Securities and Markets Authority (ESMA) published an update on its proposed guidelines for fund names using ESG or sustainability related terms. ESMA had originally proposed the guidelines in its consultation paper of November 2022.

The update set out 1) a number of changes to the proposed guidelines and 2) ESMA's decision to postpone adoption of the guidelines until the European Commission's separate review of the UCITS and AIFMD directives is complete.

The postponement aims at ensuring the guidelines align with the outcome of the directives' review. The potential overlap arose from a provisional agreement under the directives' review which would give ESMA new mandates to develop guidelines specifying the circumstances where the name of an AIF or UCITS is unclear, unfair, or misleading. ESMA intends to publish the guidelines following the expected entry of these mandates.

The changes to ESMA's proposed guidelines include:

- A change to the sustainable investments thresholds required to use sustainability-related name terms.

- A new category of "transition related terms" intended to avoid penalising funds which use such terms in their names and support the transition to a greener economy in their strategies.

- Measurable impact requirements for the use of "transition" and "impact" related name terms.

- A separation in the treatment of "environmental", "sustainability" and "governance" related terms. Where ESG terms are combined, the guidelines are to apply cumulatively.

The guidelines will apply three months after the date of their publication. Managers of new funds are expected to comply from the date of the guidelines' application, while managers of pre-existing funds will have a further six months to comply.

Payments

Fiat-backed Stablecoins regulatory regime

On 30 October the Treasury announced plans to regulate cryptoassets, under a phased approach, under powers set out in FSMA 2023. The first stage will initially focus on fiat-backed stablecoins that may be used as a form of payment, followed by the wider cryptoasset regime. On 6 November the Bank of England published a Discussion Paper, setting out its proposed regulatory framework for systemic payment systems using stablecoins and related service providers. On the same day, the FCA published its own discussion paper on regulating fiat-backed stable-coins.

It is proposed that the FCA will regulate the issuance and custody of fiat-backed stablecoins under the Financial Services and Markets Act 2000 (**FSMA**), and the use of these stablecoins as a means of payment under the Payment Services Regulations 2017 (**PSRs**).

The new regime differentiates "regulated stablecoins" from "approved stablecoins":

- Regulated stablecoins are fiat-backed stablecoins, issued in the UK by FCA authorised firms, which can be used as a means of payment.

- Approved stablecoins are fiat-backed stablecoins issued from outside the UK (overseas stablecoin) seeking to maintain a stabilised value of the cyptoasset by reference to one or more specified fiat currencies. The current proposal is that such overseas stablecoins will be approved by a "payment arranger" (to be authorised under the PSRs by the FCA) before being used as payments in the UK.

What is a fiat-backed stablecoin?

The Treasury defines fiat-backed stablecoins as a cryptoasset that seeks or purports to maintain a stable value by reference to a fiat currency and by holding fiat currency, in whole or in part, as backing. This definition will not be limited to particular currencies.

Related publications

The Bank of England also published a "Dear CEO" letter, "Innovations in the use by deposit-takers of deposits", which sets out the concerns that customers may become confused by firms offering e-money or regulated stablecoins under the same branding as their deposits, so they recommend that deposit-taking entities should only provide innovations in digital money to retail consumers in the form of deposits. If firms intend to innovate the way they take deposits (eg tokenised deposits) they should do this in a way that makes them eligible for FSCS depositor protection.

The Bank of England also published a cross-authority roadmap on innovations in payments, setting out how the different regulatory regimes would interact.

According to the Roadmap, the Bank and FCA are expecting to publish rules for consultation in H2 2024, with the new regime to be implemented in 2025.

US enforcement against Binance Holdings Limited

On the 21 November 2023, Binance Holdings Limited (**Binance**) and its Chief Executive Officer, Changpeng Zhao, pleaded guilty to money laundering violations, and Zhao agreed to step down from the world's largest crypto exchange as part of a settlement with US law enforcement and financial regulators. The settlement with the Commodity Futures Trading Commission (CFTC) will allow Binance to continue operating, and resolves allegations of the company's criminal wrongdoing.

Zhao agreed to pay $4.3 billion (£3.4bn) to settle the Department of Justice's investigations into violations related to the Bank Secrecy Act failure to register as a money transmitting business, and the International Emergency Economic Powers Act.

The SEC investigation into Binance, launched in June 2023, is ongoing.

HMT "Future of Payments" Review

On 22 November 2023 the Treasury published a report on its Future of Payments Review, which it had started in July. It makes the following points/recommendations:

- Some recommendations relating to strong customer authentication (SCA) requirements that could make things smoother for consumers at the point of purchase.

- Issues relating to digital exclusion could be adding to the financial exclusion problem (access to cash) and should be closely monitored.

- The consumer-to-consumer bank transfer process is clunky due to the need to enter account numbers and sort codes and needs improvement. Also, many merchants and retailers are frustrated by the costs of taking card payments, and the lack of viable alternatives.

- The lack of any consumer dispute resolution process for open banking transactions will be a barrier to adoption if not addressed. Similarly, the current commercial arrangements do not create the conditions for open banking to thrive in a healthy way, with costs and benefits misaligned.

- In respect of fraud and scams, the focus should be on preventing the crime in the first instance. The Payment Systems Regulator (PSR) should review the new rules on authorised push payment (APP) fraud rules after 12 months of implementation and the government should set a more ambitious fraud crime reduction target beyond 2024.

Authorised push payment fraud and mandatory reimbursement

We published an article on APP fraud and the new mandatory reimbursement rules earlier this month.

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