all things

Regulatory

for the

FUNDS & ASSET MANAGEMENT INDUSTRIES

Merlys

Summer Update 2020

We hope that all our clients, friends and their colleagues and families remain safe and well. This is a short bulletin to up-date you on recent developments while you may be taking a well-deserved break but need to catch up on those developments. The following are in a rough date order and do not indicate any priority.

1. Brexit — equivalence in financial services

The UK left the EU on 31 January 2020 and is now in a transition period (due to expire on 31 December 2020) during which it continues to be treated as part of the EU's single market ("Transition Period"). This means that UK and EU firms continue to have reciprocal rights of access under various single market directives (also known as "passporting").

At the end of the Transition Period, UK firms will lose their "passports".

If there is no agreement between the UK and the EU to recognise the UK's regulatory regime as "equivalent" to that of the EU in a specific area, UK firms will need to:

– rely on national regulatory regimes (where discretion lies with individual EU member states); or

– establish licensed offices or put in place other arrangements within the EU to service their EU clients.

The end of the Transition Period should not prevent EU clients requesting services from UK firms at their own initiative, on a "reverse solicitation" basis, as is currently the case for EU clients engaging firms outside the EU. As a result, the UK and the EU have been discussing possible equivalence arrangements that could come into force following the end of the Transition Period, including the UK's proposal for a legally enforceable regulatory co-operation framework.

Thus far the parties have not been able to agree the position on "equivalence". The EU may still decide to grant UK firms market access under the EU's standard unilateral equivalence regime (as opposed to the model put forward in the UK's proposals), but it is doubtful whether all of these will be in place by the end of the Transition Period.

The UK has published its proposals to allow UK regulators (notably the PRA and FCA) to establish co-operation arrangements with the relevant regulatory authority or authorities for an EU member state. This will enable the UK regulators to take regulatory decisions concerning EU firms or products before the end of the Transition Period. The majority of EU firms and products that currently benefit from passporting arrangements in the UK are expected to continue to do so under the UK's equivalence regime.

2. UK Senior Managers & Certification Regime (SMCR) — extension of certain deadlines

The SMCR replaced the long-standing "approved persons' regime" as the primary framework for personal conduct and accountability standards within the UK financial services sector. Initially the SMCR covered only banks, insurers and systemically important investment firms. Subsequently it was extended, with effect from 9 December 2019, to cover all authorised firms, including those firms regulated solely by the FCA such as investment advisers and fund and asset managers (referred to by the FCA as "FCA solo-regulated firms" in their SMCR publications).

The FCA extended (on 30 June 2020) the deadline for FCA solo-regulated firms to undertake their first fitness and propriety assessments of Certified Staff from 9 December 2020 to 31 March 2021. In addition, the FCA's Conduct Rules for staff who are not Senior Managers or Certified Staff (as well as the requirement to submit data to the FCA for its directory of individuals) will also now apply from 31 March 2021.

Despite these extensions, the FCA has advised firms to continue with their programmes of work for the above areas, and, wherever possible, to complete certifications earlier than March 2021. The FCA has emphasised that firms should not wait to remove staff who are not "fit and proper" from certified roles.

3. New Swiss Marketing Regime

On 1 January 2020, new rules for marketing private funds to investors in Switzerland came into force. Managers can choose, until the end of 2021, whether to market funds under transitional rules (broadly the same rules as in 2019) or move to marketing under the new rules- but there are some requirements that will apply to all managers marketing funds in Switzerland starting from late 2020.

The reason that managers may choose to market under the new rules because, now the circumstances in which they must appoint a Swiss Representative and Paying Agent are more limited — broadly, only when marketing to high-net-worth investors.

A move to the new rules may also allow managers to dismiss Swiss Representatives and Paying Agents for existing funds. When marketing under the new rules, managers will, however, need to comply with new conduct and organisational requirements and should be aware that some investors have different options open to them.

It is important to note that managers marketing to investors in Switzerland (including those who do not market under the new rules) must register with an ombudsman in Switzerland by 24 December 2020. Similarly, by 20 January 2021, all managers must consider whether they need to register staff marketing funds in Switzerland on a register of "client advisers" or if an exemption from having to do so is available to them.

4. Revisions to European Market Infrastructure Regulation ("EMIR")

As of 18 June 2020, Financial Counterparties (such as banks) are solely responsible for the reporting of OTC derivatives transactions entered into with certain Non-Financial Counterparties under EMIR. Buy-side Financial Counterparties, such as funds managed from the EU, will be required to continue reporting OTC derivatives transactions.

Previously, all EU counterparties (whether Financial or Non-Financial) were generally required to report OTC derivatives transactions. However, as of 18 June, the obligation to make the relevant report is that of the Financial Counterparty alone, in certain circumstances.

Non-Financial Counterparties (such as under-fund EU SPVs that only use derivatives for hedging) that do not exceed the EMIR clearing thresholds no longer need to independently report OTC derivatives transactions entered into with Financial Counterparties in the EU — this now being the obligation of the Financial Counterparty only.

5. Market Abuse Regime (MAR)

In May 2020, the FCA published its market conduct newsletter that focused on the FCA's expectations in the context of the COVID-19 pandemic (see FCA Market Watch 63).

It should be noted that the FCA drew attention to the increased capital-raising events taking place and the risks associated with alternative working arrangements. The FCA emphasised the importance of firms having the right controls in place regarding inside information. The FCA indicated that firms should give particular focus on several areas including appropriate identification and handling of inside information, robust surveillance and suspicious transaction reporting, identification and management of conflicts of interest and compliance with short selling regulations. The FCA emphasised its continued focus on monitoring, investigating and enforcement in these areas.

6. ESG

EU initiatives on ESG are continuing to progress and have not been delayed by COVID -19 or economic situations. Recent developments include:

– Taxonomy Regulation (22 June 2020) to support the development of a common language and uniform criteria to identify the extent to which economic activities may be considered environmentally sustainable;

– a consultation by the European Supervisory Authorities ("ESAs") on the regulatory technical standards (RTS) for the content, methodologies and presentation of the required disclosures on the ESG disclosure requirements under the Disclosure Regulation (23 April 2020). The Disclosure Regulation imposes new obligations on financial market participants and financial advisers (including fund managers and relevant investment firms); including more transparency on how ESG risks are integrated into investment decision-making or advisory processes and increased

disclosure for financial products that target sustainable investment objectives or promote environmental characteristics. The ESAs' consultation; and

– associated draft changes to (among others) MiFID II and AIFMD, intended to integrate sustainability considerations into areas such as firms' organisations, operations, risk management processes.

Firms should now be thinking about their approach to ESG matters, developing their awareness of the new EU ESG rules and considering putting ESG planning updates on their compliance agenda.

7. FCA discussion paper on the UK prudential regime for MIFID investment firms (IFR and IFD)

The EU Investment Firms Regulation and Directive ("IFR" and "IFD", respectively) came into force on 25 December 2019. Most of their requirements are due to apply to MIFID investment firms from 26 June 2021. Although the UK has exited the EU, the UK Government and the FCA have both stated their intentions to put in place a prudential regime that mirrors the IFR/IFD, for UK investment firms authorised under MIFID II.

The key impact of IFR/IFD is the introduction certain fundamental changes to the prudential rules applicable to firms falling within its scope. This will include UK-based investment advisory and management firms authorised under MiFID II. The rules will apply to such firms depending on whether they are classified as "investment firms" (in which case a baseline set of requirements apply), or "small and non-interconnected investment firms" (in which case, a subset of such requirements will apply).

The baseline changes that are applicable to "investment firms" include:

(i) the introduction of new methodologies for the calculation of regulatory capital (which, for some types of MIFID firms, may potentially result significantly increased minimum regulatory capital requirements);

(ii) new liquidity requirements;

(iii) internal capital adequacy assessment requirements;

(iv)enhanced regulatory reporting and public disclosure requirements; and

(v) employee remuneration requirements, which include maintaining an "appropriate ratio" between fixed and variable remuneration; paying out at least 50% of variable remuneration in certain instruments; deferring at least 40% of variable remuneration over a 3–5 year period, and implementing malus and clawback provisions in remuneration structures to help protect a firm's regulatory capital in the event of financial distress.

The FCA has now set out it interpretation and observations of key features of the IFD/IFR regime, including the above, intended to form the basis for the new prudential regime

applicable to UK MIFID investment firms. The FCA has requested comments and responses to the discussion paper by 25 September 2020, and has noted its intentions to publish a consultation paper later in 2020.

Firms should now assess how they will be classified under the IFR/IFD, and ahead of the FCA publishing its consultation paper, familiarise themselves with the corresponding requirements under the new rules. They should also consider, at a high level, the potential impact to their governance and compliance arrangements.

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