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Slaughter and May's banking and investment services column: October 2020

by Financial Regulation group, Slaughter and May

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The Financial Regulation group at Slaughter and May, including partners Ben Kingsley and Nick Bonsall, and professional support lawyer Selmin Hakki, regularly share their thoughts with Practical Law Financial Services subscribers on topical developments in the banking and investment services sector.

In their column for October 2020, Ben, Nick and Selmin consider recent regulatory developments relating to LIBOR transition, the FCA's September 2020 consultation paper on its approach to the authorisation and supervision of international firms, and the European Commission's ambitious Digital Finance Strategy and related legislative proposals in the area of cryptoassets.

LIBOR transition: empowering the FCA

In recent months the regulatory rhetoric on LIBOR transition has swayed from the urgent: "end-2021 may still seem some time away, one really important message ... you can't wait until 2021 or the last part of 2021 before you take action", to the cautionary: "it's just not safe to keep relying on Libor. And it's not good for your business either", to the reassuring: "you are not in this on your own: for those needing to transition, there is help, and lots of it."

There is one overriding message in all this: focus on transition remains necessary and desirable.

Some important LIBOR transition targets for the loan markets, set by the Working Group on Sterling Risk-Free Reference Rates (RFRWG), bring this imperative home:

- By the end of Q3 2020 (so, now) lenders should be able to offer non-LIBOR linked products to their customers.
- After the end of Q3 2020, lenders should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021 (through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives).
- There should be no new issuances of sterling LIBOR-referencing loan products that expire after the end of 2021 by the end of Q1 2021.

These milestones were first published by the RFRWG in January 2020 and updated in April 2020 in recognition of the fact that it would not have been feasible to complete transition across all new sterling LIBOR linked loans by the original end-Q3 2020 target.

Since our previous column, we have learned that a new toolkit will be made available to the FCA to manage and direct an orderly wind-down of LIBOR to reduce disruption for holders of so-called "tough legacy" contracts (that is, contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended).

The FCA will be able to direct a change in the methodology used to compile a critical benchmark such as LIBOR where the benchmark is no longer representative of the underlying market, the benchmark's representativeness will not be restored and where action is necessary to protect consumers and/or to ensure market integrity. This will allow for continued publication of a temporary "synthetic" benchmark rate.

Contrast this to the US, where the Alternative Reference Rates Committee has set out a less elegant legislative response that involves automatically inserting a recommended benchmark replacement as a LIBOR fallback in relevant New York law-governed agreements contracts.

The new FCA powers will be taken forward in the forthcoming Financial Services Bill, as trailed in June in the Chancellor's written statement. This will involve amending the Benchmarks Regulation ((*EU) 2016/1011*) as amended itself by the Financial Services and Markets Act 2000 (Benchmarks) Regulations 2018 (*SI 2018/135*)

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(UK BMR). For more information, see Practice note, UK implementation of Benchmarks Regulation (BMR): Government plans to amend UK BMR through Financial Services Bill 2019-21.

If there is an easy legislative fix to the transition problem, why go to the trouble of amending or remediating contracts? Because use of the FCA power is emphatically not an alternative to transition. It cannot be relied on where parties can agree replacement reference rates that are commercially acceptable, in particular transactions. A change in methodology won't be appropriate or feasible in all cases (for example, where robust input data in the relevant currency is not available). Moreover, counterparties who rely on the methodology change enabled by the legislation will not have any certainty or control over its economic terms or their future obligations.

We do not yet have a copy of the UK legislation, so we don't know what the new, more robust methodology will look like (although the FCA has indicated that it is likely to involve a fixed credit spread adjustment that reflects the expected difference between LIBOR and risk free rates). In the meantime, there are a few further particulars in an FCA statement and Q&A. And the regulator is also expected to publish statements of policy on its approach to the use of the powers in due course, following further engagement with stakeholders in the UK and internationally.

Meeting the FCA's expectations for international firms

The FCA has published a long-awaited consultation paper (CP20/20) to help international firms understand its expectations as they prepare their applications for full UK authorisation. With the TPR notification window re-opening on 30 September 2020 and a few short months until go-live date (and a potential tsunami of authorisation applications to follow), CP20/20 "could help inform firms' decisions about how they might want to structure their businesses to provide regulated financial services in the UK".

It focuses on the application of the relevant minimum standards for authorisation to international firms, as well as the potential for these firms to cause harm, the level of these risks and the mitigations available. It pinpoints three potential risks as particularly relevant for such firms, especially those operating from branches:

- Less effective protection for a UK office's retail customers, through redress and supervisory oversight for example, especially if the international firm becomes insolvent or exits the UK (retail harm).
- Lack of alignment between the UK rules that protect client money or custody assets safeguarded through the UK office and the home state insolvency regime which become applicable if the international firm fails. This misalignment could negatively impact the outcome for UK clients (client assets harm).
- Shocks or risks that originate from the international firm's overseas offices could, in some circumstances, be more difficult to detect or prevent and could be passed easily to its UK office, affecting the stability and integrity of the UK markets in which it operates or to which it is connected (wholesale harm).

A credible applicant for authorisation will need to convince the FCA that it understands the risks associated with its product or business and that it has thought carefully about, and can explain, the possible mitigants. Factors that might reduce the risk of retail harm, for instance, include the level of prudential scrutiny and supervision applied to firms in their home state, the extent of any ongoing monitoring of recovery and wind-down plans, and the degree to which UK authorities may be involved in the recovery and planning process.

Other points of note:

- An active place of business in the UK is a pre-requisite for authorisation, and this must be more than a UK registered address.
- Senior managers who are "directly involved in managing the firm's UK activities" will need to spend an "adequate and proportionate amount of their time in the UK", although individuals with "purely strategic" responsibilities for a UK branch do not need to be based in the UK.

The FCA notes that it must be able to effectively supervise services provided to UK customers by international firms operating from overseas. It will consider how much assurance it can take from its supervisory relationship with the firm's UK establishment:

"[f]or example, the extent to which the UK branch has oversight of activities provided to UK customers from overseas. Where we identify specific risks of harm arising from services being provided from an establishment outside the UK... we may invite the firm to consider providing some or all of these services from the UK branch, or where appropriate we may agree limitations or requirements with the firm that sufficiently mitigate the risk."

Compliance with the minimum standards in CP20/20 is only one part of the story. A requirement to be "ready, willing and organised" seems to have also become a more central piece of the authorisation journey. In

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theory, this means an applicant needs to have all the supporting documentation prepared and have the necessary arrangements in place to comply with the regulatory framework from day one. This makes for an interesting comparison to the PRA's mobilisation concept, which enables new banks that are not quite ready, willing or organised to "benefit from the certainty of being authorised to help them to secure further investment, recruit staff, invest in IT systems and commit to third-party suppliers."

The FCA asserts that it not proposing to change existing rules or provisions through the consultation and believes that the approach it has applied to date has been "appropriate and proportionate"; but it wants to publicly set out its approach and the factors it takes into account.

Comments on CP20/20 are due by 27 November 2020.

The EU keeps tabs on stablecoins

The European Commission has unveiled an ambitious Digital Finance Strategy, accompanied by a legislative proposal on cryptoassets that:

"clarifies the application of existing EU rules to cryptoassets, introduces a pilot regime for cryptoassets covered by these rules and establishes a new EU legal framework for cryptoassets that are not covered by these rules, based on a taxonomy of definitions of different types of cryptoassets. The latter includes utility tokens and dedicated rules to regulate the particular risks for financial stability and monetary sovereignty linked to asset-referenced tokens (also known as "stablecoins") used for payment purposes."

Here's a soundbite from the accompanying Q&A:

"The objective of the European Commission is ... to regulate innovation in, not out. In that respect, the Commission believes that regulating so-called "stablecoins" is necessary to support innovation and preserve financial stability and investor protection."

For stablecoins not covered by existing EU financial services legislation, the Commission recommends a blended approach to regulation:

- A bespoke legislative regime aimed at addressing the "specific risks posed by stablecoins".
- Regulatory alignment with the second Electronic Money Directive (*2009/110/EC*) (2EMD) for specific categories of stablecoins, to avoid regulatory arbitrage between stablecoins that are indistinguishable from e-money and the treatment of e-money issued on a distributed ledger.

The measures would apply to the following categories of stablecoins:

- E-money tokens (EMTs), that "purport to maintain a stable value by being denominated in (units of) a fiat currency".
- Asset-referenced tokens (ARTs), that "purport to maintain a stable value by referring to the value of several fiat currencies, one or several commodities or one or several cryptoassets, or a combination of such assets". So-called "algorithmic" stablecoins are excluded.

The proposal would affect issuers of cryptoassets ("any person offering cryptoassets to third parties") and providers of crypto-asset services in the EU (e.g. custodians, asset managers, exchanges and other trading platforms, brokers and dealers). EMT issuers would need to be authorised under, and comply with, the EMD. EMT holders will have a direct claim against the issuer, with a right to request the redemption of EMTs at par value upon request (subject to a fee). Own fund requirements are as per the EMD (2% ratio), more for significant EMT issuers.

ART issuers would be subject to a bespoke authorisation regime, with own fund requirements equal to at least 2% of the average amount of reserve assets, or 3% for significant issuers. There won't be an automatic right of redemption/direct claim for holders, other than minimum rights where, for example, the market value of ARTs varies significantly from the value of the reference assets or the reserve assets.

The proposal also requires the publication of a white paper (spelling out information on the cryptoasset in question, the project and planned use of funds, among other things) before any offer of EMTs/ARTs to the public, with exemptions available for issuances to qualified investors and small issuances.

There are more onerous requirements for issuers of "significant" ARTs and EMTs (deemed as such according to customer base size, transaction volumes, reserve size of the reserve, extent of cross-border activities etc), including more stringent capital and interoperability requirements, governance-related requirements, and custody and investment rules in respect of the reserve.

The Commission is also proposing a pilot regime for market infrastructures that wish to try to trade and settle transactions in financial instruments in cryptoasset form. This "sandbox" will allow for temporary derogations from existing rules so that regulators can gain experience on the use of distributed ledger technology (DLT) in market infrastructures, while

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ensuring they can deal with risks to investor protection, market integrity and financial stability.

There are a handful of other intriguing aspects of the package that we will return to in another column: a new retail payments strategy; proposals to address concerns over bias and legal uncertainty in artificial intelligence; and a draft "Digital Operational Resilience Act" including an oversight framework for cloud computing service providers, among others.

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