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Slaughter and May's banking and investment services column: January 2021

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 January 2021, Ben, Nick and Selmin consider the end of the Brexit transition period and the possibility of UK divergence from the EU rulebook, as well as the harmonisation of environmental, social and governance (ESG) disclosures, and the EU's plans to counter the influence of third country sanctions.

Happy New Year to all our readers.

From convergence, to equivalence and divergence

The end of the Brexit transition period has inevitably prompted questions about the possibility of UK divergence from the EU rulebook and the risks that this might pose to the UK's (still-to-be-granted) equivalence status.

In November 2020 it was announced that the UK government's post-Brexit approach to financial services would "*be guided by what is right for the UK….hailing the start of a new chapter for UK financial services*". The EU rhetoric is equally clear: it is keeping an eye on the direction of travel, waiting for "more information" before deciding whether UK financial services regulation can be deemed "equivalent" (see these European Commission Q&A). The UK-EU Memorandum of Understanding (MoU) expected by March 2021 will presumably codify the framework for balancing any policy choices on UK future regulatory design against appropriate transparency and dialogue with the EU, though note that the MoU in no way guarantees positive equivalence determinations.

It's apparent though that the UK is already some way down the path of rethinking its regime, in a number of clearly defined areas listed below, based on an overall agenda of prioritising and positioning the UK's credentials as an international financial centre.

The "*first step in shaping a regulatory framework for the UK's financial services sector outside of the EU*" is the Financial Services Bill, which has now completed the report stage of the Parliamentary process. The Bill purports to "*achieve similar intended outcomes*" as certain EU regimes such as the IFD and IFR, and CRR II, with "*targeted deviations*" to reflect "*the structure of the UK market and how it operates*." (see the June 2020 policy statement update on prudential standards in the FS Bill).

HM Treasury is also gathering responses to its call for evidence on the overseas framework. It is looking, in particular, at the Overseas Person Exclusion, the Financial Promotion Order, recognised overseas investment exchanges and investment services equivalence under MiFIR, all with the objective of ensuring UK legislation attracts business, whilst supporting financial stability. At the same time, HM Treasury is examining suggestions for altering aspects of the Solvency II regime through a review, the first stage of which is a call for evidence.

And let's not forget that we are in the midst of phase II of the UK regulatory framework review, which will consider the potential adaptation of the FSMA regulatory framework through the division of responsibilities between the government, Parliament and the regulators. These topics are currently also being considered by the House of Commons Treasury Committee in an ongoing inquiry on the future of financial services.

Meanwhile, the UK FinTech Strategic Review, led by Ron Kalifa OBE, is due to report back imminently, with potential implications for the regulation of FinTech in the UK. There's also the review and possible reform of the UK's listing regime, conducted by Lord Jonathan Hill and his taskforce. The first stage of the payments landscape review is in progress too; this review aims to

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ensure that the UK maintains its cutting-edge status in the payments sector.

In the longer term, a wholesale overhaul of UK financial services regulation may well be desirable, not least to simplify the jumble of EU-derived, FSMA-founded and handbook-based regulation that now comprises the UK rulebook.

ESG disclosure standards: a flurry of harmonisation

The COVID-19 pandemic has brought a new sense of focus to the question of what it means to be a responsible business. With this, there is an ever-increasing acceptance by firms of the importance of high-quality sustainability disclosures, referred to in a recent speech by Andrew Hauser (Executive Director of Markets at the Bank of England) as one of the "*building blocks of change... for turning the vision of a resilient carbon neutral economy into reality*".

There is now an abundance of ESG standards, frameworks and requirements and, consequently, concerns about their consistency. See for example the FMLC's comments in a letter of September 2020:

> "...international standards on sustainability-related disclosure requirements are not aligned or convergent, which creates uncertainty in relation to reporting obligations vis-à-vis cross-border investment activities. The lack of a common global reporting standard for non-financial information gives rise to different and sometimes conflicting requests for information from a range of stakeholders - including regulators across jurisdictions, investors, shareholders, NGOs and rating agencies. ... Greater global convergence on reporting requirements is desirable. Convergent international standards elevate the effectiveness of the standards themselves, as well as facilitating efficient cross-border transactions and promoting awareness and compliance."

Or as Mr Hauser put it: "*...fragmentation of standards is no basis for a viable global capital market for climate risk... given the importance of consistent climate disclosures, further definitive convergence is needed, and soon.*'

There have been some significant moves towards creating consistent sustainability disclosure standards in recent months. And it appears that 2021 could be the year for an explosion in standard-setters attempting to "harmonise".

In September 2020, five sustainability standards organisations: the CDP (formerly the Climate Disclosure Project), the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB) published a statement of intent to work together to create a globally accepted and comprehensive corporate reporting system. They subsequently wrote an open letter to Erik Thedéen, Chair of IOSCO's Sustainable Finance Task Force, to reiterate this shared commitment. In response, Mr Thedéen welcomed a consultation by the Trustees of the International Financial Reporting Standards (IFRS) Foundation about possible ways in which the Foundation might contribute to this project, by broadening its current remit beyond the development of financial reporting standards. The IFRS Foundation's consultation paper on Sustainability Reporting proposed the establishment of a Sustainability Standards Board (SSB) which would operate in parallel with the International Accounting Standards Board (IASB).

The group of five has since published a prototype climate-related financial disclosure standard organised around the four "pillars" of disclosure recommended by the Task Force on Climate-related Financial Disclosures (TCFD).

The Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) will merge this year to create the Value Reporting Foundation, in another move towards harmonisation of ESG reporting standards. The SASB has also announced a collaboration with the GRI, which is supported by the IIRC. Meanwhile, the Value Reporting Foundation and CDSB have jointly signalled interest in entering into exploratory discussions in the coming months.

Understandably there are questions about how these proliferating initiatives will fit together, some of which are addressed in *FAQs*.

It's worth taking a step back from this frenzy of harmonisation to consider a notion underlined by the British Academy in its Principles for Purposeful Business that a business should be structured around the question of why it exists - in other words, its corporate purpose - and everything else, including appropriate reporting and disclosure, should flow from that. So, while disclosure might be the common entry point for a firm addressing its ESG priorities, disclosure by itself plainly does not make a sustainable business.

What's in the EU's extra-territoriality toolbox? Plans to counter the influence of "third country" sanctions

The EU Commission has recently published a Communication, entitled "The European economic and financial system: fostering openness, strength and

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resilience". There are a handful of intriguing points in the paper (including, curiously, barely a mention of the UK's exit), but we focus in this column on a particular theme, namely the EU's plans to achieve "*... more rapid, robust and effective implementation and enforcement of EU sanctions, as well as a stronger policy to tackle the unlawful extra-territorial application of unilateral sanctions and other measures by third countries.*"

This objective is presented as going hand in hand with promoting the international profile of the Euro and ensuring a resilient financial sector, allowing the EU "*to defend its interests internationally and stand up for its values, using all tools at its disposal*."

A range of measures are under consideration including:

- Setting up in 2021 a Sanctions Information Exchange Repository as a database for reporting and exchange of information between the Commission and member states on the implementation and enforcement of sanctions.
- Establishing a dedicated system for anonymous reporting of sanctions evasion, including whistleblowing.
- Working with member states to ensure that national penalties for breaching EU sanctions are effective, proportionate and dissuasive.

The Commission also plans to set up an expert group on sanctions and extra-territoriality to cover technical aspects of the implementation of the EU Blocking Regulation, which we have discussed previously (see Article, Slaughter and May's banking and investment services column: July 2018).

Most notably, there is a suggestion that the EU should consider powers to block acquisitions of EU businesses in circumstances where the acquisition could increase the likelihood of third country sanctions impacting EU trade and finance. Note the following excerpt:

> "When assessing the impact of foreign direct investments into the EU on security and public order, the Commission will also consider the likelihood that the transaction results in the unlawful extra-territorial application of sanctions adopted by any third country to the EU target. For example, when reviewing the acquisition of control over EU companies by a foreign investor, the Commission may need to assess, in cooperation with the Member States' national authorities, whether this would render the EU target company more prone to abide by such extra-territorial sanctions, regardless of the country that imposed them. Such an outcome could thereby endanger the capacity of the EU target company to maintain critical infrastructure in the EU, or to ensure security and continuity of supply of critical inputs into the EU."

A practical example might involve the EU seeking to block the acquisition by a US acquirer of an EU bank or financial markets infrastructure operator in retaliation for the US seeking to impose its influence via the threat of secondary sanctions on EU businesses.

We shall keep an eye on this theme and report back on developments.

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