

# Financial Regulatory Observer

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The *Financial Regulatory Observer* spotlights selected topics currently driving regulatory and technological changes in the financial industry.

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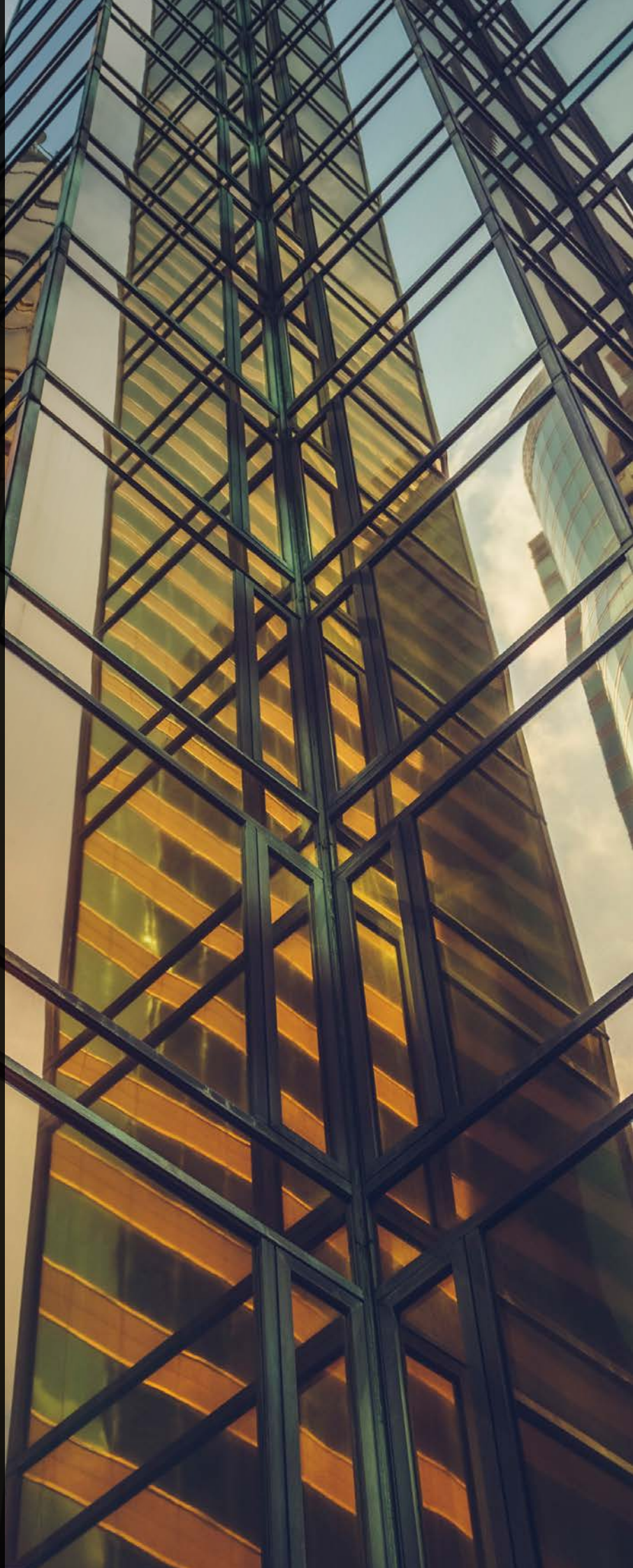
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### Regulatory round-up

As the world emerges from the turmoil caused by the COVID-19 pandemic, the financial services sector is going through a time of considerable change. This section highlights some developments to be aware of in key regulatory hot topics.

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# Shaking up the wholesale markets: UK, EU and US approaches

As lawmakers look to reform aspects of wholesale markets regulation, the UK may be poised to drift closer to the US.

By Jonathan Rogers, Claudette Druehl, Dr. Carsten Lösing, Kristen DiLemmo and Anita Edwards

In his Mansion House speech on July 1, 2021, Rishi Sunak, the then-Chancellor of the Exchequer, announced his vision to improve the competitiveness of the United Kingdom's financial services sector while maintaining high regulatory standards. This launched HM Treasury's *Wholesale Markets Review*, which sought input from stakeholders across the financial services sector.

HM Treasury published its Consultation Response in March 2022, and its proposals will be implemented through a combination of legislation and regulatory developments. The UK's Financial Services and Markets Bill 2022-23, which proposes a broad range of changes to the UK's financial services sector, incorporates a number of the recommendations proposed in the *Wholesale Markets Review*. In parallel, the UK's Financial Conduct Authority (FCA) has been tasked with implementing some of the new proposals through new and existing regulatory powers.

This article focuses on some of the upcoming changes that are driven by the *Wholesale Markets Review*, and examines how these changes may impact infrastructure providers and market participants. We assess the developments through the prism of three core themes: addressing economic inefficiencies; improving securities regulation; and moving from legislation to regulation.

We will also look at similar reform initiatives in the European Union and the United States, and examine whether the UK's approach



suggests a drift from its continental neighbors toward a closer alignment with the US.

## ADDRESSING ECONOMIC INEFFICIENCIES

The recast Markets in Financial Instruments Directive (MiFID II) introduced a number of structural reforms to the securities regulatory framework in the EU (including, at the time, the UK). These reforms were driven, in part, by the 2008 financial crisis, as there was an increased emphasis on market transparency and the need to strengthen investor protection. Several of the proposals introduced by the *Wholesale Markets Review* seek to address developments in the UK economy since MiFID II was implemented.

## Trading venues and systematic internalizers

When MiFID II took effect in 2018, it imposed various operational conditions on multilateral trading facilities (MTF) and organized trading facilities (OTF). One of the aims of the *Wholesale Markets Review* was to assess whether these changes were beneficial, or whether they had the unintended effect of discouraging new market entrants and stifling innovation.

One of the restrictions imposed by MiFID II was to prohibit MTF operators from engaging in matched principal trading to avoid conflicts of interest arising where an MTF operator wanted to execute a trade on its own trading venue. The UK government agreed with the majority

of respondents that this prohibition was costly and unnecessary, as MTF operators are already obliged to identify and manage conflicts. Separately, the consultation sought views on whether OTFs—which are fundamentally non-equity venues—should be permitted to execute derivative package trades that include an equity product. This change would allow a derivative package trade to be executed in its entirety on an OTF, rather than splitting execution across two venues. The UK government agreed with respondents that this change would cut unnecessary costs and reduce execution risk.

The FCA has been tasked with implementing these changes as part of the Future Regulatory Framework, which is a parallel initiative to reform the UK's financial services regulatory framework post-Brexit.

The *Wholesale Markets Review* also addressed regulatory requirements that may have had a negative economic impact on systematic internalizers (SIs). SIs are investment firms that deal on their own account when executing client orders outside of a trading venue on an organized, frequent, systematic and substantial basis. The MiFID II definition of “systematic internalizer” introduced complex quantitative calculations that apply on an asset class basis in which the calculations have to be updated periodically. The *Wholesale Markets Review* notes that many firms choose to opt out of the regime rather than engage with the calculation requirements. The UK government supported the move from a quantitative to a qualitative definition, which would allow more firms to opt into the regime without carrying out costly and burdensome calculations. This is reflected in the bill, which uses a qualitative definition and provides the FCA with the power to specify how it should be interpreted.

### Share trading obligation

A major outcome of the *Wholesale Markets Review* is the proposed removal of the share trading obligation (STO) that was implemented as part of MiFID II. The UK's STO applies to shares that are admitted to trading on a trading venue, and requires investment firms to trade them on a UK-regulated market, a UK MTF, through a UK SI, or on an overseas venue that the HM Treasury has



assessed as equivalent. Although the purpose of this requirement was to increase transparency, respondents noted that the removal of the STO would allow firms to trade in the most liquid market and achieve the best execution for their clients.

The UK government agreed with this view, and, accordingly, the bill proposes removing the STO. This would be a significant change for UK investment firms, as it would allow firms to trade in-scope shares on any UK or non-UK trading venue (subject to separate MiFID-derived requirements to achieve the best execution).

### Algorithmic trading

Another economic impact identified by the *Wholesale Markets Review* was in the algorithmic trading space. MiFID II requires firms that engage in algorithmic trading to enter into market-making agreements with trading venues as a condition to pursuing market-making strategies. Respondents supported the removal of this requirement because it was an additional cost and did not meaningfully contribute to market quality. The FCA is considering the best way to implement this change as part of the Future Regulatory Framework.

### IMPROVING SECURITIES REGULATION

In addition to reducing what it identified as unnecessary costs and burdens on market participants, the *Wholesale Markets Review* sought to improve certain aspects of the UK securities regulatory framework.

#### Market outages

One of the consultation's key focus areas is how to improve market resilience during a market outage. In early 2022, the FCA consulted on how it could use its current tools to clarify what should happen when there is a market outage, and it plans to put forward proposals later in the year. A primary focus of this effort will be on delineating the responsibilities between market operators and participants, and a possible outcome may be the development of a playbook for trading venues and participants to follow during an outage.

#### Equity markets

A number of the proposed changes in the *Wholesale Markets Review* are aimed at improving the operation of the equity markets. For example, HM Treasury recommended the removal of the double volume cap (DVC), which was introduced by MiFID II and limits the amount of trading

that can happen without pre-trade transparency. Respondents argued that the DVC was arbitrary and unhelpful, noting that there were no negative impacts on price formation since the FCA suspended the DVC for UK and EU securities in 2021. The UK government supported this view, and the removal is reflected in the bill.

Another change aimed at improving the functioning of the equity markets is a proposed adjustment to the tick size regime. The tick size regime sets minimum increments by which prices for equity and equity-like instruments can change, and limits the ability of trading venues and SIs to cross at the midpoint. The regime was introduced by MiFID II to prevent tick sizes from being used as a competition tool between venues because it was detrimental to the price formation process.

While the *Wholesale Markets Review* is supportive of the tick size regime, it proposes that trading venues should be allowed to follow the tick size applicable to a share's primary market (even if overseas). This is in contrast to the current position where tick sizes are calculated based on trading volumes on the most relevant market (in terms of the share's liquidity) in the UK and EU, which can lead to unnecessarily large tick sizes and increased costs. The FCA sought views on

its proposals to implement this change as part of its consultation on Improving Equity Secondary Markets and is considering the responses. The *Wholesale Markets Review* also proposed allowing trading venues to establish tick sizes for new shares rather than the FCA making an estimate of liquidity. The FCA plans to carry out further work on this proposal at a later date under the Future Regulatory Framework.

### **Aligning trading and clearing obligations**

MiFID II introduced a derivatives trading obligation (DTO) that requires in-scope firms to trade certain classes of derivatives on a UK trading venue or an overseas venue that the HM Treasury has assessed as equivalent. This operates alongside the mandatory clearing obligation under EMIR (European Market Infrastructure Regulation), but, crucially, without legislative alignment: The DTO and the clearing obligation apply to different categories of firms. Following the recommendation in the report, the bill realigns the counterparties in scope of the DTO with those that are in scope of the clearing obligation under EMIR<sup>1</sup>. To future-proof the position, the application of the DTO will expressly link to the application of the clearing obligation. The EU

is considering a similar alignment of its DTO with the scope of the EU clearing obligation as part of its proposed reforms.

### **MOVING FROM LEGISLATION TO REGULATION**

The *Wholesale Markets Review's* third core theme is a move from prescriptive legislative requirements in favor of regulatory powers to presumably allow for increased flexibility, particularly in cases where the regulator may need to act quickly to address market movement.

#### **Derivatives trading**

One of the proposals would give the FCA permanent power to modify or suspend the DTO to prevent or mitigate disruption to the markets, which is reflected in the bill. The UK government is also proposing to delegate the transparency regime for fixed income and derivative instruments to the FCA to reduce complexity. To that end, the bill removes the current legislative regime and provides new rule-making powers to the FCA to develop a new regime.

#### **Transparency waivers**

MiFID II introduced pre-trade transparency requirements and a system of waivers that may be used in specific circumstances to waive pre-trade transparency requirements. While pre-trade transparency aids price formation and helps firms achieve best execution, the system of waivers recognizes that transparency in every circumstance can impair liquidity. Trading venue operators may apply to the FCA to use some or all of the available pre-trade transparency waivers on their venue.

Rather than continuing with a system where the conditions for using pre-trade transparency waivers are enumerated in legislation, the *Wholesale Markets Review* proposed a new rule-making power for the FCA in which the FCA determines when pre-trade transparency waivers are permissible and how they are to be applied. The revocation of the existing system is reflected in the bill, as are the FCA's new powers.

#### **Market data**

As part of its changes to the EU market data framework, MiFID



It proposed a new category of regulated firm: a consolidated tape provider (CTP). A CTP is authorized to collect trade transparency data from trading venues and data reporting service providers, and then consolidate them into a continuous electronic live data stream. The purpose of a consolidated tape is to bring price and volume data about a particular financial instrument into a single place to provide a full view of the market.

There was little appetite in the private sector to take up this regulated function because, in part, the prescriptive requirements for the operation of a consolidated tape made the proposition commercially unworkable. A CTP would need to ensure that the requisite percentage of the market was captured in the consolidated tape, which would present a particular challenge for the non-equities market.

In an effort to move away from the problematic requirements set forth in the legislation, the *Wholesale Markets Review* proposes that the FCA should be responsible for establishing requirements for an authorized CTP. The FCA has been consulting on certain changes to support the development of a UK-consolidated tape.

## EU DEVELOPMENTS

The EU financial markets experienced a substantial regulatory overhaul when MiFID II was implemented, affecting both the EU27 countries and the UK. Following Brexit, however, each additional amendment to the regulatory regime poses the risk of the UK and EU regimes moving in different directions. This is particularly true for the European Commission's new legislative proposals to reform MiFID II and the Markets in Financial Instruments Regulation (MiFIR).

### Reviewing MiFIR and MiFID II

The European Commission's review of MiFID II and MiFIR helped to identify ongoing issues and potential amendments to improve the competitiveness and security of the financial markets. For example, it found that (i) information barriers were preventing share price transparency for investors in EU capital markets;

(ii) market fragmentation was preventing smaller asset managers and banks from accessing market data across different venues as easily as investment banks and other highly technically equipped market participants; and (iii) a lack of accurate, timely information on prices and available volumes of traded securities was causing continued liquidity and trade execution risk in the market.

To address these issues, the Commission proposed amendments to MiFID II<sup>2</sup> and MiFIR<sup>3</sup>, with the aim of achieving a Capital Markets Union, and, as a result, provide investors with more opportunities to participate in the European financial markets, thus increasing market liquidity in the long term. The changes also seek to promote an efficient internal market for trade by improving transparency and the availability of market data, creating a level playing field among execution venues and ensuring that EU market infrastructures remain competitive internationally.

### Changes addressing economic inefficiencies

As in the UK, several of the proposed EU amendments seek to address economic developments since MiFID II took effect. For example, the requirement for all multilateral systems to operate as a regulated market, MTF, or OTF, and the provisions on the distinction between an MTF and an OTF, are moved from the MiFID II to MiFIR, making them directly applicable under EU law (rather than through transposition by the Member States). This move is intended to increase harmonization among EU member states and improve financial stability in the EU market.

Another change is the proposed removal of the "open access" obligation for exchange-traded derivatives. The requirement for clearing infrastructures in the EU to clear derivatives trades that are not executed on their vertically integrated trading platform would be deleted to strengthen EU clearing markets.

The Commission is also proposing a ban on payment for order flow (PFOF), which is controversial in some Member States. PFOF involves a broker receiving remuneration from a market maker in exchange

## 2021

PFOF practice came under heavy scrutiny following the GameStop scandal

for passing on client orders to them. The ban on PFOF was proposed to prevent the practice of certain high-frequency traders organized as SIs paying high commissions to brokers so that they would channel their retail orders to them for execution—a practice that came under heavy scrutiny in 2021 following the GameStop scandal. Although the proposed ban aims to protect investors, it has been argued that it would increase trading costs for retail market participants and that a detailed review of the execution of private client orders would be more sensible than a complete ban. It remains to be seen whether the ban will be implemented in the EU: PFOF is banned in the UK<sup>4</sup>, and the US is also considering whether to ban or restrict the practice<sup>5</sup>.

Other proposed changes to the EU rules include (i) removing the best execution reporting obligation for execution venues, which was found not to give investors an efficient comparison or to be necessary if a consolidated tape was implemented; and (ii) deleting the requirement to register as a securities company for those dealing on its own account using direct electronic access (DEA) to help level the playing field with third-country individuals who access EU venues through DEA without registering.

### Changes that improve securities regulation

Similar to the UK, the EU is also proposing changes aimed at improving aspects of the EU securities regulatory framework.

While the UK plans to remove its DVC, the EU plans to replace the current DVC mechanism (under which the volume of anonymous trading in an equity instrument must not exceed 4 percent of the total trading in that instrument or 8 percent of total trading within the EU) with a single volume cap.

Whereas the UK is planning to remove its STO, the EU is proposing to define the perimeter of the EU STO to include shares admitted to trading on an EEA (European Economic Area) regulated market and with an EEA ISIN (international securities identification number), and establish an EU "official list" of shares subject to mandatory trading. An exception from the STO is made

for shares traded on a third-country trading venue in the national currency, while other exceptions (for example, ad hoc, irregular and infrequent transactions) are deleted.

Like the UK, the EU is also planning to improve its consolidated tape rules to enable the emergence of one CTP for each asset class. All trading venues and SIs will be required to make market data available to the respective CTP and, thus, the quality of that data will be improved by harmonizing data reports and introducing standards for quality of service applicable to all CTPs. These key changes should lead to a comprehensive overview of prices and volumes of traded equity, and quasi-equity financial instruments and, it is hoped, result in stronger, more transparent and more competitive EU financial markets.

Finally, with sustainability continuing to be an increasingly hot topic, the EU has introduced a number of changes to MiFID II through its new Delegated Regulation (EU) 2021/1253, which took effect on August 2, 2022. Under the regulation, investment advisors must obtain information about the sustainability preferences of their clients and take them into account when selecting financial products. The choice of a particular financial instrument is considered part of a client's "sustainability preferences" if it falls within the EU taxonomy, is "sustainable" under the Sustainable Finance Disclosure Regulation, or if the instrument considers the most significant adverse effects on sustainability. Investment advisors now also have a far-reaching duty to disclose the sustainability objectives of a product and corresponding risks.

## US DEVELOPMENTS

Similar reforms may be on the horizon in the US where US Securities and Exchange Commission (SEC) chair Gary Gensler used a June 2022 speech<sup>6</sup> to outline plans to reform the US equity market. The changes, which were at the "proposed rule stage" on the SEC's regulatory agenda for spring 2022, aim to modernize requirements around equity market competition and structure, including those concerning order routing and PFOF, conflicts of interest, best



The EU has introduced a number of changes to MiFID with sustainability in mind

execution, market concentration, pricing increments, transaction fees, core market data and disclosure of order execution-quality statistics.

The US proposals have some similar themes as the proposed UK changes. Like several of the UK changes, the potential SEC reforms are intended to address recent economic developments, including the heightened interest in certain "meme stocks" in January 2021 that led to increased market volatility. Following those events, the SEC identified a need for greater transparency. The SEC proposals include rule updates to provide investors with more useful disclosure about order execution quality.

Gensler, a driver for the changes, also noted the need to "look for opportunities to freshen up our [SEC] rules to ensure America remains the gold standard of the world's capital markets," suggesting a desire to focus on maintaining strong US regulation in all areas. An example of this is the SEC's recommended changes to its tick size regime to level the playing field by harmonizing tick sizes across different market centers and reducing the minimum tick size to better align with off-exchange activity. The SEC is also considering its own best execution rules for equities and other securities; these rules are currently imposed by other US self-regulatory bodies on broker-dealers, but not by the SEC, which relies on common law obligations to establish the broker-dealer's duty of best execution.

## CONCLUSION

Although the EU and the US are both considering reforms that follow similar themes to those proposed in the UK, several of the UK's proposals go further than the EU's by removing or reducing restrictions intended to protect market participants in the interest of improving efficiency in securities markets. The UK's removal of the STO, for example, arguably reduces transparency in the interest of best execution, while the EU plans to retain the obligation, albeit in an amended form. The UK is removing the double volume cap, again, potentially reducing transparency for efficiency, whereas the EU is swapping it for a single volume cap. Moreover, the deletion in the UK of the MiFID II requirement for firms

engaging in algorithmic trading to enter into market-making agreements with trading venues also suggests a move away from the EU approach. With the US still to confirm the details of its plans for reform in this area, it is possible that we are starting to see the UK's post-Brexit rules diverging from those of the EU and drifting closer to the approach taken across the pond.

1 Regulation (EU) 648/2012 on over-the-counter derivatives, central counterparties and trade repositories

2 Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/65/EU on markets in financial instruments, available here

3 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 600/2014 on enhancing market data transparency, removing obstacles to the emergence of a consolidated tape, optimizing trading obligations and prohibiting receiving payments for forwarding client orders, available here.

4 <https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf>

5 [https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822#\\_ftnref16](https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822#_ftnref16)

6 [https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822#\\_ftnref16](https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822#_ftnref16)



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# Operational resilience in the UK, EU and US: A comparison

With a new operational resilience framework in force in the UK and similar reforms proposed in the EU and the US, we examine how the regimes compare and their practical impact on financial services firms.

By Douglas Landy, Jonathan Rogers, Alessandro Zappasodi, Licia Mongiello, Anita Edwards and Roseann Cook

Operational resilience has become an area of increasing focus in the financial services sector in recent years. Reforms to the prudential framework for banks following the 2008 financial crisis, along with resulting structural changes, strengthened financial resilience, but did not address operational resilience. The Basel Committee on Banking Supervision (BCBS) noted in 2021 that further work was necessary to strengthen banks' ability to absorb operational risk-related events such as pandemics, cyber incidents, technology failures and natural disasters, which could cause significant operational failures or wide-scale disruptions in the financial markets. The COVID-19 pandemic that began in 2020 dramatically brought operational resilience into sharp focus, and 2022's geopolitical developments, energy market and infrastructure stress, and high-impact climate change events have kept operational resilience near the top of the agenda.

## DEVELOPMENTS IN THE UK, EU AND US

### A new UK regime

A new operational resilience regime took effect in the United Kingdom on March 31, 2022, introducing requirements for UK banks and insurers to ensure the UK financial sector is operationally resilient. The new regime, introduced by the UK's supervisory authorities, the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and Bank of England (BoE), seeks to improve the operational resilience of firms and financial market infrastructures (FMI), and to protect consumers,

the broader financial sector and the UK economy from the impact of operational disruptions.

In developing the framework, the UK supervisors presumed that disruptions will occur that will prevent firms and FMIs from operating as usual and providing their services for a period of time, as occurred, for example, during the COVID-19 pandemic. The rules are intended to ensure firms and FMIs plan and deliver improvements to their operational resilience so they can respond effectively when a disruption does occur.

Under the UK regime, firms and FMIs must identify their "important business services" that could impact clients or the financial system if disrupted, set an "impact tolerance" for disruption to each of those services, and ensure they can continue to deliver those services and remain within their impact tolerances during severe (or extreme, for FMIs), but plausible scenarios. The framework takes an outcome-based approach to enable boards and senior management to identify important business services and set impact tolerances that are appropriate for their firm and clients.

To further enhance the stability of the financial system, a new statutory framework has been proposed in the Financial Services and Markets Bill 2022-23 to manage systemic risks posed by "critical third parties" (CTPs). The proposals give the supervisory authorities powers to assess and strengthen the resilience of material services (such as cloud computing and data analytics) provided by CTPs to the financial sector under outsourcing arrangements.

### EU proposals

In the EU, a new regulation on digital operational resilience for the financial sector (known as the Digital Operational Resilience Act or DORA) was proposed by the European Commission in September 2020 and a provisional political agreement was reached by the European Parliament and Council of the EU in May 2022. Like the UK regime, DORA aims to improve the operational resilience of financial institutions, albeit with a focus on digital, or information and communication technologies (ICT) risk. The European Commission flagged in its proposal the continued challenges posed by ICT risks to the operational resilience, performance and stability of the EU financial system, noting that post-crisis reforms had not fully addressed digital operational resilience.



**The Basel Committee on Banking Supervision noted in 2021 that further work was necessary to strengthen banks' ability to absorb operational risk-related events such as pandemics, cyber incidents, technology failures and natural disasters, which could cause significant operational failures or wide-scale disruptions in the financial markets.**

The DORA proposals address this gap by enumerating detailed and comprehensive rules on digital operational resilience, including provisions on firms' ICT risk management and incident reporting, requirements for thorough testing of ICT systems, and providing powers to financial supervisors to oversee risks stemming from firms' dependency on ICT third-party service providers. The powers relating to third parties will be set out in DORA's oversight framework of pan-European critical ICT service providers (CTPPs), which aims to ensure operational risks are no longer addressed exclusively through outsourcing arrangements put in place by financial institutions, but also directly at the CTPP level.

In addition, given the fragmentation within the existing EU legal and regulatory framework for ICT risks and operational resilience in the financial sector—the rules that apply vary depending on the type of financial entity and among member states—DORA aims to ensure harmonization of these rules across the EU.

### **Consolidating the US regime**

The US federal banking regulators have formally recognized that the banking organizations they regulate have experienced in recent years significant challenges from a wide range of disruptive events, including technology-based failures, cyber incidents, pandemics and natural disasters, which may be further exacerbated by the increasing reliance on third-party service providers to deliver their products and services. As a first step, the US regulators, including the Federal Reserve Board, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, have sought to identify and consolidate existing guidance that can be used to form the framework for an effective operational resilience regime for those banking organizations deemed systemically important; that is, with either at least US\$250 billion in total assets or at least US\$100 billion in total assets and US\$75 billion or more in cross-jurisdictional activity, short-term wholesale funding, average nonbank assets or off-balance sheet exposures. Second, the US federal banking

regulators have focused on issuing new rules to help banking organizations establish and maintain the tools needed to identify and address evolving cybersecurity risks.

For the first area of focus, the consolidated guidance, known as Sound Practices to Strengthen Operational Resilience (Sound Practices), was issued simultaneously by the three federal banking regulators to outline the sound practices large banks are expected to have in place to address risks to operational resilience such as cyberattacks, natural disasters and pandemics. The Sound Practices include concepts from existing rules and guidance on operational risk management, business continuity management, third-party risk management, cybersecurity risk management, and recovery and resolution planning. Among other things, the guidance sets the expectation that covered firms will use existing governance and operational risk management rules to establish a specified "tolerance for disruption," essentially a risk appetite based on the capabilities of the firm's operating environment to support a disrupting event.

The second area of focus of US banking regulators is the increasing and ever-evolving nature of cybersecurity risk. The Sound Practices highlight the practices that firms should have in place to address cybersecurity risk, including using established industry risk assessment tools such as the FFIEC Cybersecurity Assessment Tool, the National Institute of Standards and Technology Cybersecurity Framework (NIST), the Center for Internet Security Critical Security Controls and the Financial Services Sector Coordinating Council Cybersecurity Profile, to measure and align cybersecurity risk with industry standards. Moreover, the three US federal banking regulators recently adopted a new Computer-Security Incident Notification Rule that requires banks and their key service providers to ensure that their incident response plans include a mechanism to identify and provide immediate notice to regulators of "material" cybersecurity incidents, including a ransomware, malware, denial of service (DoS) attack, or other hacking or similar incident. An attack or



**As a second step, the US federal banking regulators have focused on issuing new rules to help banking organizations to establish and maintain the tools needed to identify and address evolving cybersecurity risks.**

incident requires notice where it has or is reasonably likely to materially disrupt or degrade the bank's ability to carry out banking operations, including delivering its products and services, or continuing to operate business lines that are material to the bank's profits and franchise value. Notice is also expressly required for any attack or incident involving any services or functions performed by the bank whose failure or discontinuance would be deemed to pose a threat to US financial stability.

### **HOW DO THE UK AND EU APPROACHES COMPARE?**

Since the UK regime is already in effect, the details of its measures are more developed than those of the EU's DORA proposals. Nonetheless, there are some interesting similarities and differences between the two regimes.

### **Scope**

The EU's DORA proposals establish an EU framework for digital operational resilience in contrast to the UK regime, which broadly addresses operational resilience. Digital operational resilience, as defined in DORA, is a financial entity's ability to build, assure and review its operational integrity from a technological perspective by ensuring it has the full range of ICT-related capabilities necessary. For UK purposes, the FCA and PRA describe operational resilience as the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover and



learn from operational disruptions and, accordingly, look beyond the technological aspect.

Although DORA focuses on digital operational resilience, it applies to a broad range of EU-regulated financial entities, including banks, payment institutions, investment firms, FMIs, fund managers, insurers and others. This is similar to the UK regime: Banks, building societies, PRA-designated investment firms and insurers are subject to both the PRA and the FCA's operational resilience rules, while other firms, including payment institutions, electronic money institutions and recognized investment exchanges must comply with the FCA requirements.

### Methodology

Under the UK regime, a firm's "important business services" are services provided to its clients, which, if disrupted, could cause intolerable levels of harm to one or more clients or pose a risk to the soundness, stability, or resilience of the UK financial system or the orderly operation of the financial markets. The rules outline a variety of factors to consider when identifying these services, including the firm's clients and their ability to obtain the service from another provider, time criticality

of the service and the number of clients receiving the service, and considerations around the impact of disruption on the firm, its legal and regulatory obligations and the broader UK financial markets and system.

Once a firm identifies its important business services, it must then consider the maximum length of time a disruption to that service could be tolerated—its "impact tolerance." Again, there are several factors (in addition to time) to consider when setting each impact tolerance such as the client base, how many clients may be adversely impacted by the disruption, the nature of the impact, potential financial losses to the clients and firm, and broadly, the impact on the firm, its reputation, confidentiality, market or consumer confidence and the UK financial system.

In the EU, the DORA proposals mandate the creation of an ICT risk-management framework that includes a digital resilience strategy, and requirements involving governance and control, ICT-related incident reporting and digital operational resilience testing. As part of that strategy, a firm must establish its risk tolerance level for ICT risk and analyze the impact tolerance of ICT disruptions—similar

concepts to those used in the UK regime. However, DORA does not currently require firms to set impact tolerances for each of their critical functions and services in the same way the UK rules do. The expectation set out in the proposed regulation is less granular, simply stating that a firm's digital operational resilience strategy should include the methods to address ICT risk and attain specific ICT objectives by "analysing the impact tolerance for ICT disruptions," among other things. It remains to be seen what additional details concerning impact tolerances will be set out in the Level 2 legislation.

Nonetheless, certain DORA requirements are similar to those in the UK supervisory framework. For example, both EU and UK frameworks require the identification of critical parts of the business (i.e., "important business services" in the UK and "critical" or "important functions" in DORA). Both regimes also require firms to carry out some form of testing—under DORA, firms must conduct business impact analyses regarding the firm's exposure to severe disruptions while, similarly, the UK provisions introduce requirements for operational resilience testing.

## Likelihood versus impact of disruption

The approach taken by the new UK regime represents a mindset change when assessing risk for operational resilience purposes. Under previous UK rules on operational resilience, firms were required to consider how likely a type of disruption was to occur in addition to the impact of the disruption when assessing risk. The new regime does not have likelihood as a factor, although the regulators' current proposals for a critical third-party regime include the likelihood of causing intolerable levels of harm to large numbers of customers as a suggested metric when assessing the potential impact of a third party's failure.

Similar to the UK regime, DORA does not ask firms to consider the likelihood that a disruption will occur, except in relation to critical ICT third-party service providers; the recitals to DORA note that firms should thoroughly assess contractual arrangements with ICT third-party service providers (especially those established in a third country) to identify the likelihood of risks emerging.

## A COMPARISON TO THE US APPROACH

While the US regulators have not yet adopted a standalone operational resilience regime similar to the UK regime, it is worth noting that the provisions that are integral to the UK regime are addressed in existing US regimes governing business continuity and resolution planning. For instance, identifying "important business services" provided and how to protect them are integral to the resolution-planning regulations that apply to US and non-US banks operating in the US. The US resolution plan rules require covered banking entities to identify operations that are material to the banking entity or as a provider to the industry, or identify operations that are critical to the financial stability of the US and, in each case, to establish a plan for the banking entity's orderly resolution that minimizes the disruption of those operations. Similarly, business continuity guidelines established jointly by the US banking regulators require banking entities to identify all critical business functions,



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assess the potential impact of their disruption, and develop a business continuity plan focused on identifying and managing any potential disruptive event, seeking to recover, maintain or re-establish continuity of services.

Like the UK regime, the US requirements are focused on identifying and mitigating the "systemic risk" to the US financial system that would be caused by a disruption or failure in the ability of a covered banking entity to continue to provide one or more important services. The US regime, however, does not address or create any expectation that a banking entity's resilience planning identify and seek to mitigate "intolerable levels" of harm to clients, absent any systemic risk to US financial stability.

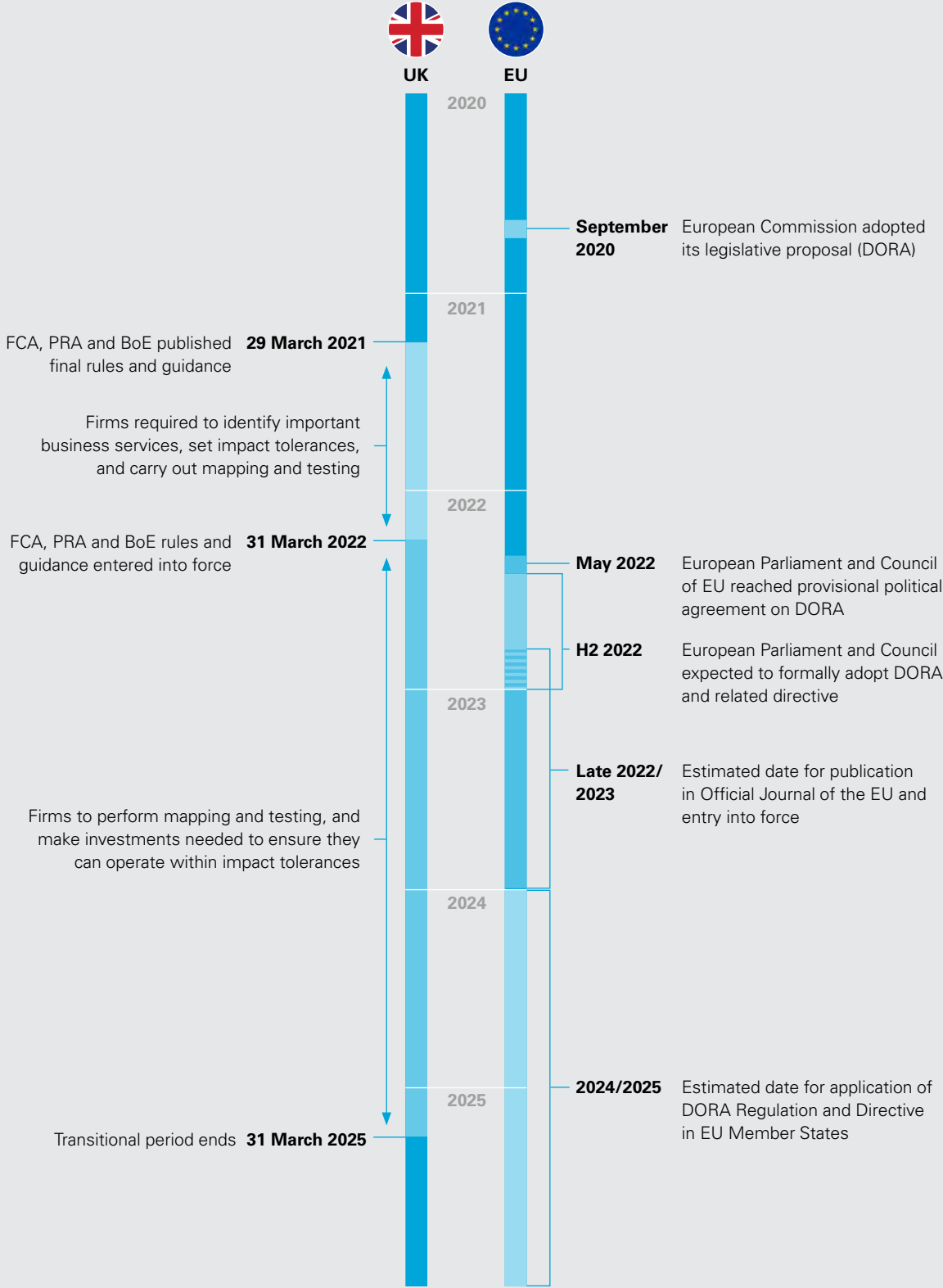
Besides the Sound Practices requirements, the US federal banking regulators have used existing rules and guidance to address emerging threats to operational resilience. For example, the US regulators issued guidance in response to the COVID-19 pandemic to explain their expectations of how banking entities should use business continuity plans to address pandemics. The guidance goes beyond ensuring the continuance of critical operations by requiring the adoption of a preventive program to address the steps to mitigate outbreaks among employees and the adoption of a strategy to address each stage of the pandemic, including mitigation controls to ensure business continuity such as cross-training employees and remote access.

## INTERNATIONAL APPROACHES TO OPERATIONAL RESILIENCE

The BCBS published the Principles for Operational Resilience in 2021 to strengthen operational resilience by increasing international engagement and promoting greater cross-sectoral collaboration to build on the work already implemented by several jurisdictions and standard-setting bodies (including in the UK, EU and the US, and at the international level by the International Organization of Securities Commissions (IOSCO)). The BCBS's seven principles, largely adapted from existing guidance issued by it or national supervisors, are: governance; operational risk management; business continuity planning and testing; mapping of interconnections and interdependencies of critical operations; third-party dependency management; incident management; and resilient ICT including cybersecurity.

In the PRA's March 2021 policy statement on operational resilience (PS6/21), which was published shortly before the finalized BCBS principles, the PRA commented on the alignment between the UK regime and the BCBS approach. The PRA explained that although the BCBS concept of "critical operations" is not identical to the UK's "important business services," it considered the terms to be aligned. The BCBS "critical operations" definition includes "critical functions" as defined by the Financial Stability Board and expanded to include "activities, processes, services and their relevant supporting assets, the disruption of which would be material to the continued operation of the bank or its role in the financial

# Operational resilience: UK and EU timelines



system” —the PRA considers this to be consistent with the reference in its policy to safety and soundness, and financial stability. The BCBS also uses the term “risk tolerance,” which is focused on a bank’s risk appetite, risk capacity and risk profile; the PRA considers this to be aligned with its impact tolerances. The PRA concluded it is realistic to assume there will be local differences in implementation of operational resilience regimes, and it is reasonable that different jurisdictions will have different views on what they consider critical or important, but, as long as the principles are aligned, firms and supervisors should be able to work effectively across borders.

In October 2021, the IOSCO published a revised *Principles on Outsourcing*, which established expectations for regulated entities that outsource tasks and briefly addressed the impact of COVID-19 on outsourcing and operational resilience. IOSCO noted that the pandemic and the increasing reliance on outsourcing that resulted from it (particularly due to the increased use of technology for remote working) were a useful reminder to increase attention to operational resilience. It also suggested that regulated entities should consider the *Principles on Outsourcing* when thinking about how to maintain and improve resilience.

At its recent meeting in July, the members of the UK and US Financial Regulatory Working Group, composed of senior staff from the HM Treasury, US Treasury Department and the financial regulatory agencies in each country, addressed the importance of operational resilience for “critical” third-party providers that provide services across borders and sectors. The regulators recognized that there would be value in developing shared international approaches to identifying critical services and providers, and to collaborate on how to address any disruptions in their services.



## The introduction of the new UK requirements concerning operational resilience is likely to have considerable practical consequences for in-scope firms.

### 2025

Firms will need to have performed mapping and testing to ensure they remain within impact tolerances for each important business service, and made the investments needed to enable them to operate consistently within those impact tolerances

### PRACTICAL IMPACTS AND CHALLENGES FOR FIRMS

The introduction of the new UK requirements concerning operational resilience is likely to have considerable practical consequences for in-scope firms. Firms will already have had to identify their important business services, set impact tolerances, carry out a certain level of mapping and testing, conduct “lessons learned” exercises involving their ability to respond to and recover from disruptions effectively, develop internal and external communications plans for when important business services are disrupted, and prepare and submit self-assessment documentation to the regulators. Going forward, firms (by March 31, 2025 at the latest) will need to have performed mapping and testing to ensure they remain within impact tolerances for each important business service, and made the investments needed to enable them to operate consistently within those impact tolerances. While March 2025 may sound far away, regulators will expect progressive improvement during this timeframe, so firms should be ready to demonstrate this when the next impact events arise.

Given the development of DORA and the ongoing re-emphasis in the US on its existing standards, it seems clear that operational resilience is a focus area for regulators over the upcoming economic cycle, and firms in all regions can expect to be required to review and, where necessary, refresh their approach.

To meet all of these requirements, firms will need to ensure they have sufficient internal resources to implement the assessments, mapping, testing and other additional actions the new regime demands. Employees may need to be trained to ensure they have the requisite skill sets and knowledge, and it will be important to ensure senior management are sufficiently informed and engaged to enable them to provide the requisite level of oversight of the firm’s operational resilience. There will also be cost implications given the requirement to invest as necessary to operate consistently within the firm’s impact tolerances. In this regard, cross-border firms will be required to adopt a consistent approach to operational resilience group-wide, and each firm will have to meet specific requirements in accordance with the relevant home-country implementing provisions.

Looking ahead, if the proposed measures to oversee critical third parties are implemented, these will have additional practical impacts, including the potential for service providers, such as cloud providers, to pass on any costs of complying with the requirements to the firms receiving those services.

<sup>1</sup> Basel Committee on Banking Supervision, Principles for Operational Resilience, March 2021

# Regulatory round-up

As the world emerges from the turmoil caused by the COVID-19 pandemic, the financial services sector is going through a time of considerable change. This section highlights some developments to be aware of in key regulatory hot topics.

By Jonathan Rogers, Harriet Baldwin, Anita Edwards and Roseann Cook

## CRYPTOASSETS



### UNITED KINGDOM

- Any person wishing to acquire “control” of an FCA-registered cryptoasset business, directly or indirectly, must now obtain prior FCA approval. This will include anyone who will ultimately own or control, directly or indirectly, more than 25 percent of the shares or voting rights
- A new “travel rule” requires cryptoasset exchange providers and custodian wallet providers to share information concerning cross-border transfers of cryptoassets above a €1,000 threshold. There is a 12-month grace period (until September 2023) for firms to implement the rule
- Implemented in stages from December 2022 to February 2023, under PS22/10, the FCA has strengthened its financial promotion rules for high-risk investments and has indicated that the rules for promoting cryptoassets are likely to follow the same approach, subject to HM Treasury bringing “qualifying cryptoassets” into the scope of the financial promotion regime
- Stablecoins and other “digital settlement assets” are set to be brought into the UK regulatory purview by the Financial Services and Markets Bill 2022-23. The changes aim to facilitate the use of certain stablecoins as a widespread means of payment, including by

retail customers, to drive consumer choice and efficiencies. “Digital settlement assets” is defined more broadly than just stablecoins to allow for regulatory flexibility

- An amendment to the Financial Services and Markets Bill 2022-23 has been agreed to by the UK Parliament, which amends the Financial Services and Markets Act 2000 to clarify that powers relating to financial promotion and regulated activities can be relied on to regulate cryptoassets and activities involving cryptoassets. “Cryptoasset” is also defined



### EUROPEAN UNION

- The proposed Regulation on Markets in Cryptoassets (MiCA) has been provisionally agreed upon by the European Parliament and Council of the EU. It is expected to be adopted by the end of 2022
- A provisional agreement has also been reached on proposals to amend and recast the Wire Transfer Regulation (WTR). Similar to the UK, the changes introduce a new “travel rule” by expanding the scope of rules on information accompanying the transfer of funds so they also apply to cryptoasset transfers, with the aim of strengthening the EU’s AML/CFT rules



### UNITED STATES

- A new Comprehensive Framework for Responsible Development of Digital Assets issued by the White House outlines potential future changes relating to financial inclusion, AML/CFT and the potential case for a US central bank digital currency
- The US Congress has introduced several comprehensive legislative proposals on digital assets in 2022. While unlikely to pass in the near future, these proposals indicate a growing interest in streamlining digital asset regulation

## RETAIL INITIATIVES AND CONSUMER PROTECTION



### UNITED KINGDOM

- The FCA has published details of its new “Consumer Duty,” aimed at raising standards of consumer protection across retail markets. Firms’ boards should now have signed off on their implementation plans for the Consumer Duty, and firms should be ready to comply with the rules by July 31, 2023 (for products and services open to sale or renewal) or July 31, 2024 (for closed products and services)
- New, stronger financial promotion rules will start to apply in the coming months for high-risk investments and firms approving financial promotions. Measures relating to risk warnings for high-risk investments take effect on December 1, 2022, while other rules will begin to apply on February 1, 2023. Details are set out in FCA policy statement PS22/10
- A strengthened regime for appointed representatives (ARs), which is intended to ensure authorized firms take more responsibility for their ARs, will begin to apply on December 8, 2022



### EUROPEAN UNION

- As part of its preparations for a new EU retail investment strategy, which aims to increase retail investor participation in the EU’s capital markets, the European Commission is expected to finalize an impact assessment shortly. The strategy was supposed to be adopted in early 2022, but it has been delayed and is now expected to be adopted in early 2023
- The EU institutions have reached a provisional agreement on proposed amendments to the regulation on European Long-Term Investment Funds (ELTIFs). One of the aims of the changes is to make it easier for retail investors to invest in ELTIFs while ensuring strong investor protection



### UNITED STATES

- The Consumer Financial Protection Bureau (CFPB) is adding to the toolkit it uses to address discriminatory practices by consumer financial services providers. Among other things, the CFPB has said that it will use its authority to take enforcement action for unfair deceptive or abusive acts or practices (UDAAP) to address intentional and unintentional violations of discrimination laws related to any consumer financial product, not just those limited to lending
- In September, the CFPB joined state regulators in taking a look at the need for increased regulation of buy-now-pay-later (BNPL) providers. The CFPB said it will issue guidance on how consumer protections under existing credit card rules apply to BNPL products, and that the data privacy protection and credit reporting practices should be extended to BNPL products





### UNITED KINGDOM

- In a Dear CEO letter, the PRA has warned that firms need to make further progress in managing climate-related financial risk. The letter provided examples of good and poor practices, and flagged that firms judged not to have made sufficient progress in embedding the PRA's expectations may be asked to provide a roadmap explaining how they will overcome the gaps
- The FCA is planning to develop "technical screening criteria" under the UK Green Taxonomy to define which economic activities are environmentally sustainable and, therefore, "taxonomy-aligned" by the end of 2022
- The government has confirmed that it plans to adopt and endorse corporate reporting standards for sustainability in line with those being developed by the International Sustainability Standards Board (ISSB)
- In CP22/20, the FCA is consulting on new rules to tackle greenwashing, with proposed measures such as investment product sustainability labels and restrictions on how terms like "ESG," "green" and "sustainable" can be used



### EUROPEAN UNION

- The proposed Corporate Sustainability Reporting Directive (CSRD) has been provisionally agreed to by the European institutions and is expected to be adopted in late 2022
- The delayed level 2 legislation underpinning the Sustainable Finance Disclosure Regulation (SFDR) will begin to apply on January 1, 2023. Commission Delegated Regulation (EU) 2022/1288 contains regulatory technical standards specifying details of the required content and presentation of taxonomy disclosures

- The EBA has published a report on incorporating ESG risks into the supervisory process for investment firms under the Investment Firms Directive. The report recommends prioritizing the recognition of ESG risks in investment firms' strategies, governance arrangements and internal processes, and later incorporating them into the assessments of risks to capital and liquidity



### UNITED STATES

- The Federal Reserve Board, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) highlighted climate risk management as a priority in their regulatory and supervisory agendas
- As a first step, the Federal Reserve Board will conduct a pilot exercise with six of the largest US banks in 2023 that will stress test the ability of the banks to manage the financial risks under various climate change scenarios. The exercise for now will not have any capital or supervisory implications, but could be used to inform future requirements
- The OCC has proposed principles for a high-level framework for climate-related financial risk management that would require large national banks to address governance, risk management and stress testing of identified climate risks
- Similarly, the FDIC proposed a high-level framework for the safe and sound management of exposures to climate-related financial risks that would apply to all FDIC-insured banks with material financial exposures to climate risk

## MARKET ABUSE



### UNITED KINGDOM

Recently, the FCA has notably issued the following fines for market abuse failures:

- A brokerage firm was fined £531,000 for failing to accurately report transactions and to bring suspicious transactions to the FCA's attention, leaving potential market abuse undetected. Two directors were also banned from holding senior positions in financial services as a result
- A large international broker-dealer was fined £12.6 million for failing to properly implement the Market Abuse Regulation trade surveillance requirements relating to the detection of market abuse. The FCA said this prevented the firm from effectively monitoring its trade activities for certain types of insider dealing and market manipulation

The FCA has also begun criminal proceedings against four individuals involved with a public limited company for fraudulent trading, alleging that they knowingly concealed the company's insolvent financial position and co-ordinated a "pump and dump" scheme to artificially inflate the share price through a series of misleading statements. A fifth individual has been charged with money laundering for laundering the proceeds from the sale of company shares



### EUROPEAN UNION

- Issuers admitted to trading on SME growth markets should ensure that the formats of their insider lists and their liquidity contracts comply with the revised requirements recently introduced through level 2 regulation
- The proposed MiCA Regulation (discussed above) includes provisions concerning market abuse. Under MiCA, market abuse involving cryptoassets is prohibited and requirements are introduced to prevent it, including bans on insider dealing, unlawful disclosure of inside information and market manipulation involving cryptoassets



### UNITED STATES

- The new head of the SEC's Division of Enforcement has said that the Division's focus will be to pursue robust enforcement, robust compliance and robust remedies. The Division is expected to focus on cybersecurity, digital assets, insider trading and the protection of material, non-public information



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