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9 June 2021

Financial Regulation Monthly Breakfast Webcast

Overview

- Recent global developments on ESG
- The FCA's proposal to introduce a "Consumer Duty"
- The FCA's consultation on its new powers relating to critical benchmarks
- The joint PRA and FCA Dear CRO letter on delivery versus payment clients

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Recent global developments on ESG

Nicola Higgs & Anne Mainwaring

ESG Transition: Impact of COP26

- Countries continue to strengthen their climate commitments, particularly in advance of delayed COP26 in Glasgow
- Already seeing:
  - UK establishing target to reduce emissions by 68% by 2030 (to supplement its 2050 net zero target)
  - EU committed to achieving net zero by 2050 and establishing 2030 target of 55% reduction
  - South Korea and Japan committed to achieve net zero by 2050
  - China committed to achieving peak carbon by 2030 and becoming carbon neutral by 2060
  - US re-joined Paris Agreement, climate change designated as a national emergency, and domestic tsar tasked with assessing US domestic climate policy

The Paris Agreement

- A **legally binding international treaty** on climate change
- Its goal is **to limit global warming** to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels
- Achieve a **climate neutral world by 2050**
- **COP26 Glasgow, November 2021**

ESG Transition: Impact of COP26

- TCFD emerging as global standard for climate reporting:
  - According to the TCFD Status Report, over 110 regulators and governmental entities from around the world support the TCFD, including: EU, UK, US, Belgium, Canada, Chile, France, Japan, New Zealand, Sweden, Hong Kong, Switzerland
  - TCFD currently appears to be a core part of the consolidation of ESG reporting standards:
    - The IFRS Foundation review on sustainability reporting
    - IOSCO Board supporting developments at the IFRS Foundation
    - WEF Common Metrics incorporate TCFD
    - Sustainability reporting organisations (CDP, CDSB, GRI, IIRC, and SASB) support incorporation of TCFD as part of common global metrics

ESG Transition: Pace of Global Change

UK Bank of England

"… changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be"

Federal Reserve Bank of NY

"Nearly all global systemically important banks, including all eight U.S. G-SIBS, have signed onto the TCFD, and many of these have started disclosing under this framework to various extents. Firms continue to be challenged in the identification and measurement of climate risk embedded in their portfolios, however, so these disclosures may take some time to develop as the industry considers how to establish common standards"

European Commission

A proposed European Climate Law will turn the political commitment of climate-neutrality by 2050 into a legal obligation. "*The ongoing COVID-19 outbreak in particular shows the critical need to strengthen the sustainability and resilience of our societies and the ways in which our economies function. This is necessary to, above all, minimise the risk of similar health emergencies in the future, which are more likely to occur as climate and environmental impacts escalate*"

IOSCO

"There is a growing consensus that, amongst other things, climate change poses significant financial risks and that urgent, coordinated action is required to address them…It is evident that if climate considerations are to be properly taken into account throughout the investment chain, we will at the very least need globally consistent corporate-level reporting standards."

Fragmentation risk
A fragmentation in group level priorities is a significant transition risk for international firms where affiliates are exposed to a different pace of sustainability transition across global jurisdictions

Converging international standards
Will the EU Taxonomy form an international standard or will different countries adopt their own approach (e.g. China & Canada)

Data credibility
Manage the risk arising from a lack of reliable and timely data for a wide array of company activities at the level of granularity anticipated by evolving regulations

ESG Transition: Snapshot of global reforms

	Global principles	EU Regulation	UK Regulation	US Regulation	APAC Regulation
Companies	UN Principles for Responsible Investment (UNPRI) TCFD recommendations on climate change reporting	Corporate Social Responsibility Directive EU Taxonomy Regulation	UK Taxonomy UK mandatory TCFD	SEC guidance, alerts, policy CFTC climate risk policy Coordinated Climate Policy Strategy Executive Order on Climate-Related Financial Risk Formal rulemaking on climate risk disclosure now agency priorities The Climate Risk Disclosure Act is advancing in the House, and would direct the SEC to issue disclosure rules within two years 2021 proxy season expected to show a further YoY increase in ESG-focused proposals	Japan FSA Draft Principles on Climate Transition Finance Singapore MAS Green Finance Action Plan

Voluntary Standards
Binding Legislation

ESG Transition: Snapshot of global reforms

	Global principles	EU Regulation	UK Regulation	US Regulation	APAC Regulation
Financial institutions	UN Principles for Responsible Investment (UNPRI) UN Principles for Responsible Banking (UNPRB) UN Principles for Sustainable Insurance (UNPSI)	Corporate Social Responsibility Directive EU Taxonomy Regulation Sustainable Finance Disclosure Regulation Low Carbon Benchmarks Regulation	UK Taxonomy UK mandatory TCFD PRA rules on climate risk management FCA rules on ESG disclosure Low Carbon Benchmarks Regulation	SEC consideration of ESG fund labelling and concerns about “greenwashing” SEC examinations of investment advisers managing ESG funds Executive Order on Climate-Related Financial Risk DOL announced non-enforcement of Trump administration’s rule change to ERISA requiring those overseeing pension and 401(k) plans to put economic interests over ‘non-pecuniary’ goals (specifically calling out ESG investing in its proposal)	HK SFC requires ESG funds to justify their credentials HKMA measures on green and sustainable banking Japan FSA Draft Principles on Climate Transition Finance Singapore MAS Green Finance Action Plan

ESG Transition: UK

FCA CP: Climate-related disclosures – Proposals to require climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers aligned with TCFD

Trust in the market for ESG/sustainable investments – next steps on FCA guiding principles for the design, delivery and disclosure of ESG/sustainable fund products

UK green taxonomy – UK will develop Technical Screening Criteria to define what activities are environmentally sustainable

June 2021

Q2/3 2021

Q4 2021

Q1 2022

Q3 2022

End 2022

Diversity in Financial Services – to support efforts in moving the dial in the financial sector, the FCA and PRA will be issuing a joint Discussion Paper on Diversity and Inclusion

FCA Final Rules: Climate-related disclosures

Diversity in Financial Services – FCA Consultation Paper

Diversity in Financial Services – FCA Policy Statement

ESG Transition: UK / EU divergence

- The UK chose not to require compliance with SFDR, and the MiFID II changes will occur post-Brexit – therefore, will not apply in the UK
- PRA’s priority is prudential climate risk (hence compulsory TCFD disclosures for banks)
- The EU’s sustainability regime is broader:
  - Captures a full range of ‘E’, ‘S’ and ‘G’ topics (i.e. the scope is beyond climate disclosures)
  - Double materiality threshold – impacts on the bank; the product / service + broader +/- societal / environmental impacts

EU	UK
ESG Risk Management	➢ Climate risk focus ➢ SMCR overlay
Conflicts of interest	TBC
Suitability	✗
Appropriateness	✗
Product governance	✗

ESG Transition: US

- Biden Administration Shifting Focus to Climate Risks
  - Since re-joining the Paris Agreement in February the Biden Administration has ramped up efforts to put the risks associated with climate change at the centre of its attention and policy direction

Policy	Purpose
Coordinated Climate Policy Strategy	US Department of the Treasury Climate Hub which will focus on a broad range of climate-related policy work, including: • Climate transition finance (mobilising financial resources for climate-friendly investments and prioritising the expedited transition of high-emitting sectors and industries) • Climate-related economic and tax policy (leveraging economic and tax policies to support building climate-resilient infrastructure and ensuring the transition to a net-zero economy) • Climate-related financial risks (understanding and mitigating the risks that climate change poses to the stability of the US and global financial system and economy)
US International Climate Finance Plan	The provision / mobilisation of financial resources to assist developing countries to reduce or avoid greenhouse gas emissions and build resilience and adapt to the impacts of climate change

ESG Transition: US

Policy	Purpose
Executive Order on Climate-Related Financial Risk	Aimed at addressing the threat that climate change poses to US financial stability. The Executive Order requires federal agencies, including financial regulators, to undertake work to advance clear and comparable disclosure of climate-related financial risks and act to mitigate such risk and its drivers. The Executive Order's "whole-of-government approach" for a government-wide climate-risk strategy calls for identifying the public and private means to achieving net carbon neutrality by 2050. To that end, the Executive Order specifically instructs Treasury Secretary Janet Yellen to work with the Financial Stability Oversight Council (FSOC) to: • Assess climate-related financial risks, both physical and transitional, to the stability of the US federal government and financial system • Share climate-related financial risk information among FSOC member agencies and other executive agencies as appropriate • Produce a report within 180 days of the order on the efforts of FSOC member agencies to integrate climate-related financial risk considerations, including any potential recommendations or current practices to enhance climate-related disclosures by regulated entities

ESG Transition: APAC

Policy	Purpose
Hong Kong: HKMA approach to green and sustainable banking	The HKMA is committed to promoting green and sustainable finance in order to address climate risk. In particular, the HKMA adopts a three-phased approach to promote green and sustainable banking: • Phase I – developing a common framework to assess the "Greenness Baseline" of individual banks. The HKMA will also collaborate with relevant international bodies to provide technical support to banks in Hong Kong to better understand the green principles and methodology in undertaking the baseline assessment • Phase II – engaging the industry and other relevant stakeholders in a consultation on the supervisory expectation or requirement on Green and Sustainable Banking, with a view to setting tangible deliverables for promoting the green and sustainable developments of the Hong Kong banking industry • Phase III – after setting the targets, implement, monitor and evaluate banks' progress in this regard

ESG Transition: APAC

<table>
<tr><th>Policy</th><th>Purpose</th></tr>
<tr><td>Japan: Draft Principles on Climate Transition Finance</td><td>The draft Principles form part of the FSA’s efforts to facilitate climate transition by ensuring the efficient flow of financing from investors to issuers wishing to address climate change risk issues and transition toward a low-carbon society. The draft Principles track the Climate Transition Finance Handbook issued by the International Capital Market Association in December 2020, which recommends that issuers disclose the following four elements:
• the issuer’s climate transition strategy and governance;
• business model environmental materiality;
• climate transition strategy to be ‘science-based’ including targets and pathways; and
• implementation transparency</td></tr>
<tr><td>Singapore: MAS Managing Director Ravi Menon keynote speech at the IMAS-Bloomberg Investment Conference</td><td>Singapore’s aim is to play a key role as a centre for green finance in Asia. In particular, Singapore is focusing its efforts on the following three areas:
• <u>Broadening the range of green financing solutions and markets</u>: Specifically, this entails (a) facilitating the issuance of more established green financing instruments (e.g. green, sustainability, and sustainability-linked bonds and loans), (b) promoting innovative disaster risk insurance products to strengthen climate risk resilience in Asia, and (c) attracting green funds and asset managers with a sustainability focus</td></tr>
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ESG Transition: APAC

Policy	Purpose
Singapore: MAS Managing Director Ravi Menon keynote speech at the IMAS-Bloomberg Investment Conference (continued)	Improving the consistency and transparency of ESG reporting and disclosure: The lack of clear, agreed definitions on the terms “green” and “sustainable” has greatly impacted investors’ ability to monitor progress in emissions reduction or measure outcomes in sustainability. As such, the MAS seeks to resolve this issue through (a) providing guidance for asset managers to assess, monitor, mitigate and disclose environmental risks, (b) developing a taxonomy to identify and classify activities that can be considered green or in transition towards green, (c) promoting active stewardship by investors to promote sustainability in their investee companies, and (d) working with other central banks and regulators to shape internationally consistent ESG reporting and disclosure Building knowledge and capabilities in sustainable finance: MAS is working to anchor in Singapore relevant centres of excellence, think tanks, and research networks. For example, Moody’s Corporation is building a comprehensive suite of ESG resources out of Singapore to spearhead its sustainable finance agenda in the Asia-Pacific. The Sustainable Finance Institute Asia, an independent research and capacity building institute, has also established its headquarters in Singapore to support the implementation of sustainable finance policy initiatives in Asia

Global ESG Opportunities & Risks

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The FCA's proposal to introduce a "Consumer Duty"

Nell Perks

Consultation Paper (CP21/13)

Proposed Consumer Duty

- Consumer Principle and supporting rules and guidance
- Applicable to all regulated firms that provide services to retail clients

Background

- 2018 / 2019 – Discussion Paper followed up by feedback statement
- Financial Services Act 2021

Consumer Duty

Key Elements

- Consumer Principle
- Cross-cutting rules
- Outcomes

Consumer Principle

- 2 options:
  - A firm must act to deliver good outcomes for retail clients
  - A firm must act in the best interests of retail clients

Consumer Duty

Cross-Cutting Rules

- Require firms to:
  - Take all reasonable steps to avoid causing foreseeable harm to consumers
  - Take all reasonable steps to enable consumers to pursue their financial objectives
  - Act in good faith

Consumer Duty

Outcomes

- <u>Communications</u> – must equip consumers to make effective, timely and properly informed decisions about financial products and services
- <u>Products and Services</u> – must be designed to meet consumers' needs, and sold to those whose needs they meet
- <u>Customer Service</u> – must meet consumers' needs, enabling them to realise the benefits of products and services and act in their interests without undue hindrance
- <u>Pricing</u> – of products and services must represent fair value for consumers

What will this mean for firms?

- A "*paradigm shift*" in FCA expectations
- "*a significant shift in culture and behaviour for many firms*"
- New measures should be considered "*at every stage*" of a firm's processes and "*at every level*" of the organisation
- Monitoring and testing policies and practices
- Principle 6 / Principle 7
- Private right of action?

Next steps

- Window for comments – closes 31 July 2021
- Further consultation by the end of the year
- New rules to be made by 31 July 2022

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The FCA’s consultation on its new powers relating to critical benchmarks

Nicola Higgs

Critical benchmarks: A recap on the UK state of play

- LIBOR is currently the only critical benchmark in the UK
- LIBOR transition experience has informed FCA's policy approach to critical benchmarks
- Post Brexit: EU BMR onshored (UK BMR)
    - UK Benchmarks Register – includes UK & EU benchmark administrators
    - FCA supervises 'use' in the UK
- Supervised UK users of benchmarks may continue to use benchmarks provided by third country administrators (including those in the EU) until 31 Dec 2025

FCA CP21/15: New powers for critical benchmarks

- FCA is encouraging firms both inside and outside the UK to review and respond to its consultation by 17 June 2021
  - Where FCA finds that the benchmark is not representative (Article 23(6)) it can require supervised contributors and supervised third country entities (including entities that are not yet contributors to the relevant critical benchmark) to contribute input data in order to maintain, restore or improve representativeness
  - The maximum period of mandatory contribution shall not exceed five years in total
- Policy Statement with final rules due in Q3 2021

FCA CP21/15: New powers for critical benchmarks

New powers

- Two new FCA powers introduced through amendments to the UK BMR
- Relate to the use of critical benchmarks that are being wound down - help reduce risk in the wind-down period

Legacy use power	New use restriction power
➢ Enables FCA to designate a critical benchmark as an ‘Article 23A benchmark’ where it has become permanently unrepresentative of the market it is intended to measure ➢ Designation as an Article 23A benchmark would result in an automatic prohibition on use of the benchmark by UK supervised entities ➢ Enables FCA to require the administrator to make changes (including the methodology) of the Article 23A benchmark ➢ Enables FCA to permit some or all ‘legacy’ use of the Article 23A benchmark	➢ Enables FCA to prohibit some or all new use of a critical benchmark when it has been notified by the administrator that the benchmark will cease to be provided

FCA CP21/15: Implementation considerations

Contractual provisions

- How do contractual terms interact with the winding down of a critical benchmark?
  - ***Fallbacks in the case of permanent cassation of a benchmark***: Not likely to be triggered while a benchmark continues to be published as an Article 23A benchmark for a wind-down period (prior to cessation of publication). Therefore, FCA's power and decisions regarding the legacy use power may be relevant to such contracts
  - ***Permanent unrepresentativeness***: The contract moves away from the benchmark at the time, or before, its designation as an Article 23A benchmark comes into effect. Therefore, the prohibition on use would not be relevant to these contracts

FCA CP12/15: Implementation considerations

- FCA expectation is that firms will consider whether contracts should be amended before the new rules take effect, taking into account the following:

1. Appropriate alternatives: which could be included in contracts as appropriate and fair replacements
2. Ease of amending the contract: the practicalities of amendments based on number of parties, consent requirements, the ease of identification of parties, and the type of legal, regulatory and operational procedure(s) required for the relevant parties to consent
3. Available mechanisms for changing large volumes of contracts without making bespoke amendments: industry practice may provide standard documents or mechanisms – or both – to allow multiple contracts to be amended
4. The nature of the parties to the contract and their likely awareness, knowledge and understanding of Article 23A designation: e.g. retail borrowers may be less likely to engage with lenders' efforts to amend the contract
5. The effect of the prohibition on parties who must consent to, or be involved in, amending the contract: whether the prohibition on use affects parties differently such that it creates misaligned incentives to amend the contract
6. Evidence that similar contracts have been amended: indicating that amendments are feasible
7. How much notice the parties have had of the prohibition

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The joint PRA and FCA Dear CRO letter on delivery versus payment clients

Rob Moulton

Dear CRO letter on DvP clients

Why now?

- Regulators have observed “a number of incidents” involving defaults by clients who transact solely in cash products settled on a DvP only basis
- Defaults typically happen during periods of high price volatility
- Some have led to material losses at firms

Dear CRO letter on DvP clients

Good practices

On-boarding of new accounts	Undertake more comprehensive checks than the usual KYC checks to establish client identity.
	Implement a risk-based policy framework to ensure that at least the basic credit profile of every client is within the firm's risk appetite. This should be developed and overseen by a credit function independent of the front office.
	Undertake more extensive credit analysis for higher risk accounts (e.g. those with no financial track record or audited financial statements).
	The salesperson or internal owner of the account should formally sign off on the agreed trading strategy for the client, including guidelines for the typical size, type, and frequency of transactions that the account would be expected to undertake.
Credit risk framework	Every client account (not just DvP client accounts) should be subject to a pre-settlement credit exposure limit, derived from a risk-based matrix or hierarchy that is developed and owned by an independent credit function.

Dear CRO letter on DvP clients

Good practices

Ongoing oversight	There should be clear internal ownership of the client account, to enable consistent monitoring.
	Implement a monitoring system that compares the actual trading profile of the client with the expected trading profile, so that any material deviation from what is expected is flagged and escalated to the salesperson, front office management, and an independent control function.
Client exposure monitoring	Implement an automated monitoring system to reconcile pre-settlement exposures to risk limits, with appropriate in-built escalation procedures. Any exceptions are systematically escalated to the independent credit function for approval.
	Settlement fail reports incorporate details in relation to pre-settlement exposure.
	In-built system triggers and trading halt parameters are established for aggregate open exposures that exceed pre-established risk limits.
	Market risk exposure is closely monitored and appropriate close-out policies and procedures are established.
Escalation procedure	Implement a robust trade fail management process, with systematic and pre-defined escalation trigger points for individual client accounts.

Dear CRO letter on DvP clients

Next steps

- Implement the good practices outlined in the letter as part of risk management of DvP clients
- Consider any conduct risk issues when implementing these measures
- Provide the regulators with an update, outlining what steps have been taken in response to the letter, by the end of the year

Upcoming Webcasts

A COMPLIMENTARY WEBCAST

Competition in Asset Management – A Practical Perspective

Thursday, 17 June 2021 | Webcast

Latham & Watkins is pleased to invite you to a webcast on competition law, which remains an important area for asset managers.

Our specialist lawyers will provide an engaging session from a UK, European and US perspective. During this session we will cover the use of, and contribution to, shared and market-wide pricing services, as well as competitor collaborations and consortia to development distribution, pricing, and trading platforms.

Other topics include:

- Recap of recent regulatory pronouncements and activity
- Consideration of risk hot-spots for competition law
- Interactive ‘real-world’ scenarios
- Look into the future – what might be on the horizon

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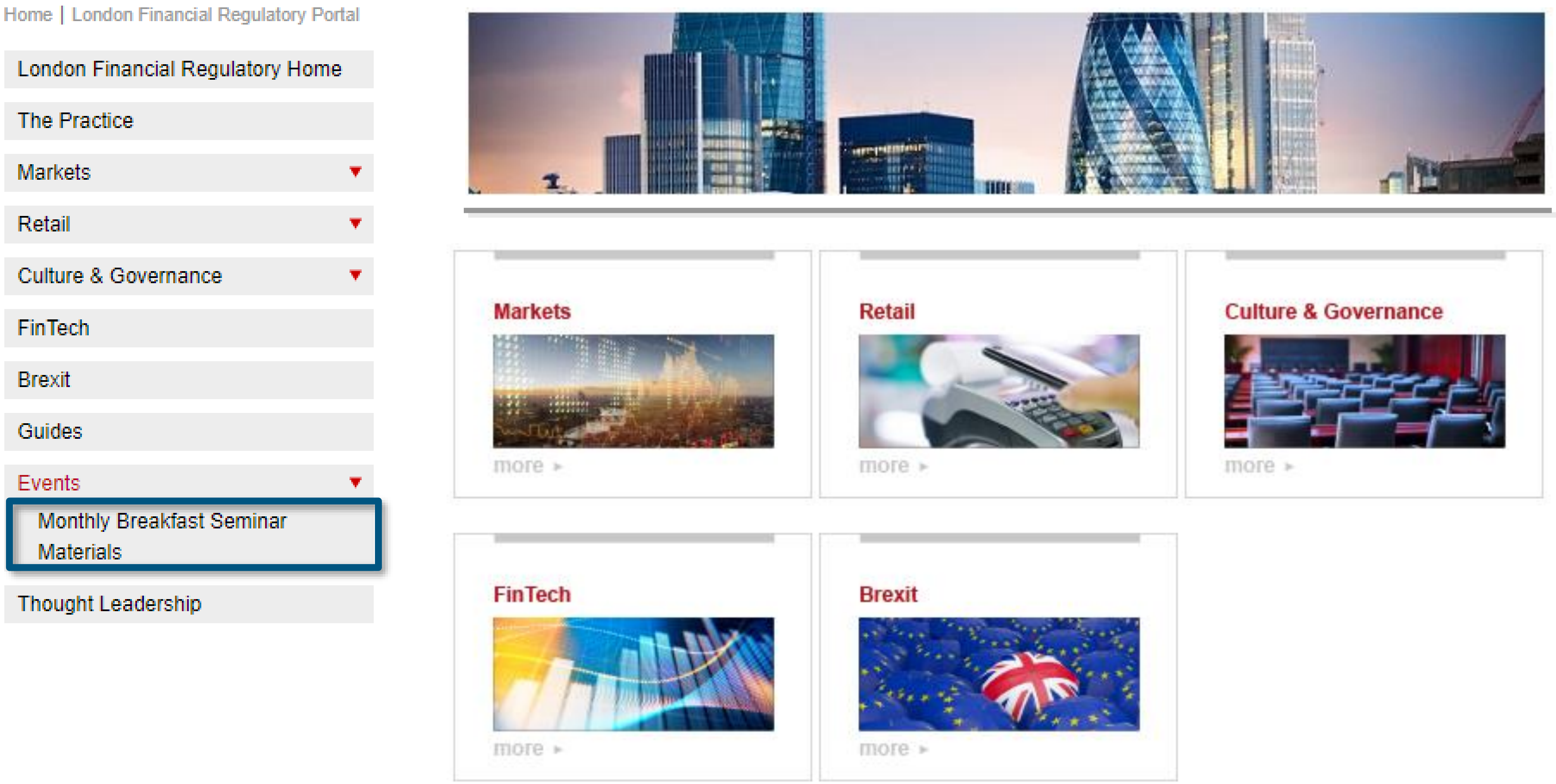

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FCA Proposes New Consumer Duty

Latham & Watkins has collaborated with the Association for Financial Markets in Europe **(AFME)** to produce: The European ESG Disclosure Landscape for Banks and Capital Markets, a new report designed to help financial institutions navigate Europe's increasingly complex ESG reporting landscape.

To access the report please click here.