

ALLEN & OVERY

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A risk management briefing on key legal and regulatory issues in the finance sector

The evolving world of financial risk

Beyond capital
and liquidity:
structural implications
of the EU's prudential
regulatory reforms

Operationalising data
ethics in the financial
services sector

U.S. continues
aggressive sanctions
and anti-money
laundering enforcement
against non-U.S. banks

Brexit day 1 readiness
for European banks
and investment firms:
risk, legal and
compliance changes
for EU firms under
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A reflection on the
current state of play
regarding how EEA
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financial services into
the UK post-Brexit

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FOREWORD



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This is not a time for the faint hearted. Navigating the complex risk landscape in which the global financial services industry has to operate has become significantly more challenging than at any time since the height of the financial crisis more than a decade ago.

Financial institutions across the world are facing intense scrutiny from policymakers, regulators and the general public over issues that may have their origins in the financial crisis but have now matured into legal, regulatory and social obligations.

The proliferation of rules and regulations relating to anti-money laundering and sanctions, and questions about how banks and other financial services firms should store, manage and use the vast lakes of data available to them are just a few of the risk management challenges that the industry continues to grapple with.

Add to this mix, the impact of the China and U.S. trade war, the far-reaching regulatory and operational ramifications of Brexit and the escalating geopolitical and economic uncertainty in key markets across the world and the picture can become immensely complicated.

Only the most well-prepared, agile and customer-centric companies are likely to thrive in today's environment.

We at Allen & Overy have published this new edition of the Risk Note with the intention of helping to inform thinking and analysis among in-house legal, risk and compliance teams. These specially selected insights from our leading lawyers provide a practical overview of some of the most pressing risks and their potential implications. I hope they provide much food for thought.

Richard Cranfield

Richard Cranfield

Beyond capital and liquidity: structural implications of the EU's prudential regulatory reforms

We look at the architecture of the new European regulatory framework and some of the key areas relevant to the corporate structure of UK and other European financial institutions.

In regulatory terms, UK and other European financial institutions have found it hard to see far past the management of Brexit. But that is set to change. New challenges lie only a short way over the horizon. We stand at the cusp of some highly material prudential regulatory reform in the form of the EU risk reduction package – comprising changes to the Capital Requirements Directive (CRD5), Capital Requirements Regulation (CRR2), Bank Recovery and Resolution Directive (BRRD2) and Single Resolution Mechanism Regulation (SRMR2) – which was finalised and published in the Official Journal on 7 June, and investment firms prudential package – comprising an Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) – which are currently being finalised.

Together, these reforms affect all European (including UK) banks and investment firms and require significant implementation over a period of multiple years. There will be material changes to the capital and funding needs of firms as well as to their governance, risk management, systems and controls, reporting, recovery and resolution planning and, in some cases, corporate structures.

NEW FRAMEWORK FOR NON-SYSTEMIC INVESTMENT FIRMS

First up, some (largely) good news. Historically, the EU has struggled with the regulation of investment firms. In this context, 'investment firms' is a portmanteau term that includes brokers, dealers, portfolio managers, investment advisers and assorted other actors in securities and derivatives markets. The EU's default approach has been to apply the same standards to banks and investment firms with limited exceptions for certain types of investment firms that have a low prudential risk profile. Subjecting investment firms to Basel standards is inefficient, and is occasionally cited as one of the possible reasons for the comparative weakness of the EU investment bank sector.

The IFD and IFR, which are expected to come into effect at the beginning of 2021, will ameliorate this situation somewhat by recasting the prudential framework for all non-systemically important investment firms. In general, this will result in the simplification and reduction of prudential requirements for such firms, although there will be some losers – proprietary dealers and commodity derivatives dealers in particular – which will become subject to meaningful harmonised capital requirements for the first time, increasing their required minimum capital substantially.

EXTENDING THE ECB'S OVERSIGHT OVER SYSTEMIC INVESTMENT FIRMS

For the systemic (so-called 'class 1') investment firms – in broad terms, those whose EU proprietary-risk-taking firms have consolidated assets exceeding EUR15 billion, or potentially less, subject to regulatory discretion – little changes on the face of things. They continue to be regulated in the same way as banks and will have to implement the changes in CRR2 and CRD5. But behind this lies some sleight of hand by the EU authorities. The IFR brings the largest class 1 firms – broadly those whose proprietary-risk-taking firms worldwide have consolidated assets exceeding EUR30bn – into the supervisory regime for banks.

For Euro-area firms, this means migration into the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). Eurozone class 1 investment firms will therefore face a change in their supervisor and resolution authority, which is likely to feed through to changes in the supervisory relationships, potential differences in the exercise of options and discretions, and questions around the carry-over of existing waivers – in addition to the challenge of implementing CRD5 and CRR2. Such firms also will be required to submit applications for authorisation to their local bank regulator (probably in Q3 2020), which is likely to prove a time-consuming disclosure exercise.

REGULATION OF FINANCIAL HOLDING COMPANIES

Unlike the U.S., the EU has not historically regulated bank holding companies. Subject to limited exceptions, CRD5 introduces a requirement for the approval of a financial holding company which – in broad terms – is the 'top' holding company in a Member State or in the EU of a group or subgroup which includes a credit institution or class 1 investment firm, or a holding company which attracts sub-consolidated supervision in the EU. Applications will need to be made with respect to existing financial holding companies by 28 June 2021. It is not yet clear how onerous the approval process will be.

Regulated financial holding companies will become subject to all of the requirements of the prudential framework in relation to their consolidated position. Regulated financial holding companies and their management will also be subject to the oversight and supervisory and disciplinary powers of the competent authority. The application of the full suite of CRD5 and CRR2 requirements for regulated financial holding companies is likely to require substantial change to their board composition and governance, in particular.

Affected groups will need to identify the relevant holding companies and build a plan to enhance their capabilities to meet the full prudential framework.

THE INTERMEDIATE PARENT UNDERTAKING REQUIREMENT

Another area in which the ECB has sought greater supervisory oversight is the regulation of non-EU institutions. The existing SSM framework confers supervisory powers on the ECB in respect of EU banks and their consolidated EU sub-groups. It does not extend to EU branches of third-country banks and does not require third-country groups to house their EU regulated holdings under a single holding company. As a result, the ECB considers it suffers from an inability to have a single consolidated view of the risks that third-country groups pose.

The ECB fought for supervisory powers in both areas, but won only in the latter: to widen ECB oversight. CRD5 includes a requirement for an intermediate parent undertaking (IPU) for a large third-country group (one whose EU-*situs* assets exceed EUR40bn) which has more than one credit institution and/or class 1 investment firm in its group, which must be in place from January 2024. All EU credit institutions and investment firms, including class 2 and class 3 investment firms, must be owned by the IPU.

Exceptionally, two IPUs may be permitted in certain circumstances. This concession was largely driven by the constraints placed on U.S. banks.


Post-Brexit, assuming the UK implements CRD5, the IPU requirement will be applied separately by the UK in respect of UK sub-groups of non-UK groups, and by the EU27 in respect of non-EU27 groups. International banks that meet the criteria in both the UK and EU27 therefore potentially face dual IPU requirements.

BRANCH REGULATION: EU BRANCHES OF NON-EU BANKS

EU branches of third-country banks are generally not subject to EU prudential standards. CRD5 does not change this position, but introduces minimum harmonised reporting requirements for branches and requires EU regulators to co-operate where there is both an EU branch and one or more subsidiaries within the EU to ensure that there is comprehensive supervision of the relevant group.

Longer term, it seems likely that branch regulation will be revisited both in Europe and the UK, albeit for different reasons. In the EU27, the lack of ECB oversight and concerns around the utilisation of branch structures to avoid aspects of EU regulation are primary concerns, whereas in the UK questions remain about whether the PRA will more meaningfully enforce its branch risk appetite given the systemic implications of having a population of very large international branches in London.

Banking and investment services providers will need to work through the corporate structural and governance implications of the new regime, prepare regulatory applications as necessary in the short term, and commence the restructuring process where they are to be subject to the IPU requirement.

Those groups that are at the margins of the IFR thresholds will need to assess which class they occupy, and may wish to consider internal reorganisations (in particular ring-fencing proprietary risk-taking activities) to mitigate their regulatory exposure. Similarly, groups with multiple financial holding companies may wish to consider optimising their corporate structure to minimise their exposure to the financial holding company regime .

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Operationalising data ethics in the financial services sector

Financial institutions have become accustomed to managing gigantic volumes of data, ranging from customer data to business intelligence and employee data. However, the financial services sector is being revolutionised by data-driven, and data-generating, technology. With the likes of mobile, blockchain and artificial intelligence reshaping traditional financial services, we are seeing the emergence of a new trend threatening to disrupt these disruptive technologies – data ethics.

Data ethics is the study and evaluation of moral problems relating to data, algorithms and corresponding practices to formulate and support morally good solutions.¹ In practice, data ethics embodies the difference between what financial institutions *can do* with data, and what they *should do* with data. In other words, where legislation and regulation form the letter of the law, data ethics represents the spirit of the law. Technologies such as artificial intelligence amplify and add new dimensions to ethical uses of data, but the concept of data ethics is technology-agnostic. This means that it is just as relevant to other data-rich activities undertaken by financial institutions, such as social listening.²

Data ethics is rapidly becoming one of the most important strategic and, given its philosophical heritage, operationally complex risk management challenges facing companies. If a financial institution is perceived to be using data in an underhand or reckless way, it could face significant consequences including loss of customer trust, regulatory investigation, and investor backlash. Indeed, Charles Randell, Chair of the UK's Financial Conduct Authority and Payment Systems Regulator, has warned that the financial sector could face its own "Cambridge Analytica moment" if it loses public trust over the way it handles data,³ signalling the growth of data ethics (or lack thereof) as a concern for regulators across the world. Additionally, investors are more actively urging companies to remedy perceived ethical deficiencies in their data management practices, suggesting that it is only a matter of time before data ethics makes its way on to the environment, social and governance (usually referred to as "ESG") agenda of organisations.

These factors have led to data ethics being an issue that no financial institution can afford to ignore. Given senior management's unique position to ensure that the concept is embedded in every relevant layer of their organisation, the following are some suggestions for operationalising data ethics:

1. "JUST BECAUSE YOU CAN, DOESN'T MEAN YOU SHOULD"

This is the core principle that should underpin every discussion and decision about data management. It can help to rebut arguments that advocate underhand or 'creepy' business propositions. This sentiment can help to shift your organisation's mindset from a compliance/tick-box approach to an approach based on values and principles.

2. ENGAGE PRINCIPALS

Ethical questions around the use of data should not be left to be determined by lawyers or compliance teams alone. These issues require engagement across a broad range of internal stakeholders, from those involved in designing and implementing digital services to those responsible for customer and business strategy. Tone from the top, engagement at all levels, and education and awareness are critical to ensuring that all internal teams understand the importance of ethical approaches to data, and the implications of getting this wrong.

3. ESTABLISH PRINCIPLES

Work with your stakeholders to develop data ethics principles. Although good ethical behaviours can be incentivised, they are more likely to come from individuals buying into a commonly held set of principles. There is a growing volume of guidance outlining the ethical principles that should underpin data processing activities – these include the European Commission's High-Level Expert Group on Artificial Intelligence, the Organisation for Economic Co-operation and Development, financial services regulators such as the Hong Kong Monetary Authority⁴ and data protection authorities such as the Commission Nationale de l'Informatique et des Libertés (CNIL) in France. Financial institutions can use this guidance as a base for creating data ethics principles that reflect/supplement the organisation's data use cases, corporate purpose, risk appetite and values. They should also think carefully about how these principles might be used in practice, and whether it is appropriate to give additional guidance on areas that are higher risk.

1. Floridi L, Taddeo M. 2016 "What is Data Ethics" Phil.Trans. R. Soc 374:20160360.

2. Broadly, social listening is the process of actively monitoring and listening to online conversations between individuals to understand what people are saying about a specific topic (such as a brand, product, service or industry).

3. "Financial sector faces 'Cambridge Analytica moment', warns FCA", Financial Times, 6 July 2018 [here](#)

4. "Use of Personal data in Fintech Development", letter from the Hong Kong Monetary Authority dated 3 May 2019 [here](#)

4. DATA CULTURE, NOT DATA VULTURE

The concept of ethics in any given society is constantly evolving, as behaviours move between ‘acceptable’ and ‘unacceptable’ in public and regulatory consciousness. This can make it challenging for organisations to be sure that they are operating in a way that is ethical, and seen to be ethical. Operationalising data ethics means establishing a framework that can, in the long term, withstand a fluid socio-cultural landscape. It is important to establish regular reviews to refresh data ethics principles, and regularly review the effectiveness of governance and internal controls to ensure that they are driving the desired behaviours (for example, responsible data use, rather than reckless data hoarding). It could also include regularly stress-testing data ethics principles against public sentiment by monitoring current affairs and engaging market researchers.

5. LEVERAGE EXISTING POLICIES AND PROCEDURES

Data ethics may seem like yet another regulatory expectation for financial institutions to comply with, but there is ample opportunity to build on risk management frameworks, impact assessments, internal policies and procedures and governance and accountability models implemented as part of an existing data privacy compliance programme or risk management approach more generally. For example, it may be necessary to decide which data ethics questions to build into template data privacy impact assessments (for use where personal data is involved), and which to include in a stand-alone ethical data impact assessment (for use in all other data use cases).

The right governance strategy may be to create new bodies or committees (such as a data ethics board), or to redesign the terms of reference for existing forums to ensure that ethical questions are addressed. Whichever approach is taken, the relevant bodies should be incorporated into the wider governance structure and have clear responsibilities and escalation protocols. To embed data ethics within a financial institution, it is essential that ethical decisions become part of the day-to-day management of the business and an issue on which senior management is kept informed.

6. ETHICS BY DESIGN

As with privacy, embedding ethical considerations into the “DNA” of products and services from the outset can save time, money and resources involved in having to redesign a product or service later. Consider including

questions around data ethics in any new product/service approval process.

7. YOU HAVE TO UNDERSTAND THE RISKS TO IMPLEMENT A REMEDY

Many people in a financial institution will have a role to play in embedding an ethical approach to data use. For example, specific data ethics considerations may be different for data scientists within an organisation, in comparison to the marketing team. It is important to make it as easy as possible for people to identify what activities are, and are not, considered to be ethical in the context of their roles. Providing risk-based, role-based training to stakeholders at all levels of the organisation is critical.

8. KNOWLEDGE IS POWER

The more you understand about the provenance of the data, why it needs to be used to achieve the business objective, and how it is to be used, the greater your ability to assess whether the data use is ethical. Due diligence is key to achieving this. For example, are you using data to mirror consumer preferences, or to manipulate them? How relevant is the data being collected, relative to the purposes of the processing? And how are the algorithms used to process the data trained, tested and validated?

9. ENGAGE THE SUPPLY CHAIN

Engage with your data supply chain and flow down (or up) your data ethics principles, for example, by interrogating the data source, and including contractual provisions to ensure the integrity of the data and the processing activities. With the proliferation of data-sharing and secondary use of data, aligning data ethics principles among members of the organisation’s data ecosystem can help to meet ethics objectives (such as transparency).

For any financial institution looking to cultivate customer trust and a sustainable business model, a core question must be: how should it collect, manage, learn from and potentially monetise the vast quantity of data available to it in a way that is acceptable in the environment in which it operates? The tips above should help to establish the tools to answer this question. The answer could prove to be critically significant, and determine whether a financial institution’s use of data creates value, or whether it exposes the organisation to a raft of costly reputational, regulatory and litigation risks 🚫

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U.S. continues aggressive sanctions and anti-money laundering enforcement against non-U.S. banks

When assessing anti-money laundering risk and exposure, global financial institutions should be mindful of the complex landscape and assertions of broad authority by U.S. authorities and banking regulators. A multinational financial institution with a U.S. branch may find its worldwide activities scrutinized by U.S. banking regulators even if its branch does not service those activities, and what's more, even without a U.S. branch, a bank may still have civil or criminal U.S. exposure for payments cleared in the United States.

Federal and state banking regulators such as the Federal Reserve Board (FRB), the New York State Department of Financial Services (NYDFS) and the Office of the Comptroller of the Currency (OCC) of the U.S. Department of Treasury, have authority over licensed financial institutions operating in the United States to assess fines and civil penalties for anti-money laundering failures and sanctions violations and to examine compliance breakdowns. Below we observe increased willingness by U.S. banking regulators to assert authority over overseas conduct at multinational financial institutions even where the conduct at issue does not center around the bank's U.S. branch or banking activities in the United States. While this broad authority may yet be contested, global banks should be aware that anti-money laundering risk management policies and processes for various lines of business that have any nexus to their U.S. branch, however minimal, may be subject to U.S. regulatory scrutiny.

In addition, even global banks with no U.S. banking license may still be exposed to enforcement actions by U.S. civil and criminal authorities for conduct beyond U.S. borders where there is a sufficient U.S. nexus such as U.S.-cleared payments, highlighted by recent public investigations. The Office of Foreign Assets Control of the U.S. Department of the Treasury (OFAC) has authority to assess civil penalties for any and all sanctions violations – knowing or not – if there is a sufficient U.S. nexus that may be as minimal as dollar payments cleared through the United States. Likewise, federal and state criminal authorities (such as the Department of Justice (DOJ), or the New York County District Attorney's Office (DANY)) have broad authority to police willful money laundering and sanctions violations where there is a sufficient U.S. nexus such as U.S.-cleared payments.

A LOOKBACK AT PRIOR RESOLUTIONS WITH U.S. BANKING REGULATORS

U.S. banking regulators, in conjunction with U.S. criminal and civil authorities, have traditionally pursued anti-money laundering and sanctions enforcement cases against multinational banks in relation to conduct that occurred in or through a bank's U.S. entity or branch (frequently in New York). Examples of this include the large sanctions (and anti-money laundering)-related settlements with HSBC, BNP Paribas, Commerzbank, Société Générale and others.

In those instances, the financial institution had a banking branch or agency in the U.S. and provided a range of

banking services in the U.S., such as payment processing, on behalf of overseas affiliates. Under these arrangements, transactions relating to customers of non-U.S. branches or affiliates were routed through the U.S. branch or entity for dollar clearing purposes. Because a U.S. branch or entity is obliged to comply with the Bank Secrecy Act's programmatic anti-money laundering requirements, these branch activities provided a touchpoint for the U.S. banking regulators to exercise jurisdiction alongside criminal and civil authorities.

In other words, even though the conduct at issue involved activities in a non-U.S. branch in connection with non-U.S. customers and entities, penalties were imposed by U.S. banking regulators for breaches by the U.S. branch processing the payments. Other recent examples include the settlement by Deutsche Bank with DFS, the FRB and the U.K.'s Financial Conduct Authority for violations of anti-money laundering laws in relation to Russian 'mirror trades' and settlements against a number of non-U.S. banks relating to FX trading by traders worldwide. These banks entered into settlements with U.S. banking regulators in relation to predominantly non-U.S. conduct where the dollar legs of the transactions at issue were cleared through the bank's U.S.-licensed entity. Most recently, in April 2019, Standard Chartered Bank entered into a joint resolution with U.S. and UK authorities in relation to sanctions violations where a majority of the USD payments flowed through the bank's New York branch.

THE UNICREDIT RESOLUTION: A CASE STUDY FOR A MULTINATIONAL FINANCIAL INSTITUTION WITH A U.S.-LICENSED BRANCH THAT DID NOT CLEAR U.S. DOLLARS

U.S. banking regulators took one step further in the recent UniCredit settlement. Announced less than a week after the Standard Chartered Bank settlement, three non-U.S. UniCredit entities entered into joint resolutions with the DOJ, DANY and OFAC, as well as two U.S. banking regulators, NYDFS and FRB, for total penalties of USD1.3 billion relating to conduct and transactions that did not center around UniCredit's U.S. branches.

Of the three entities, the parent, UniCredit S.p.A., and the German subsidiary, UniCredit Bank AG, had licensed New York branches subject to NYDFS and FRB oversight, while the Austrian subsidiary, UniCredit Bank Austria AG, had no U.S. affiliation. The resolution papers detailed that certain UniCredit employees outside of the United States utilized cover payments, stripping (changing or removing

U.S. AUTHORITIES AND BANKING REGULATORY BODIES WITH AUTHORITY OVER ANTI-MONEY LAUNDERING AND SANCTIONS-RELATED VIOLATIONS AND CONDUCT REFERENCED IN THIS NOTE

United States Department of Justice (DOJ) – The federal executive department of the U.S. government, responsible for the enforcement of U.S. laws and the administration of justice.

New York County District Attorney's Office (DANY) – The executive department of the state of New York government, responsible for the enforcement of New York laws and the administration of justice.

Office of Foreign Assets Control (OFAC) – A financial intelligence and enforcement agency of the U.S. Treasury Department that administers and enforces economic and trade sanctions in support of U.S. national security and foreign policy objectives.

Federal Reserve Board (FRB) – The central bank of the United States whose responsibilities include supervising and regulating financial institutions and banking operations in the U.S.

Office of the Comptroller of the Currency (OCC) – An independent bureau within the United States Department of the Treasury that serves to charter, regulate, and supervise all national banks and thrift institutions and the federally licensed branches and agencies of foreign banks in the U.S.

New York State Department of Financial Services (NYDFS) – The department of the New York state government responsible for regulating financial services and products, including those subject to the New York insurance, banking and financial services laws. The Department supervises many different types of institutions including New York State-chartered or licensed financial institutions.

identifying information from payments or instructions), front companies and book-to-book transfers to facilitate transactions by sanctioned entities – similar to conduct that has served as a basis for enforcement actions against other financial institutions in the past. But unlike the other multinational banks mentioned previously such as Standard Chartered, UniCredit relied primarily on third-party correspondent banking to provide USD clearing services to its customers, not its New York branches.

NYDFS stressed that the various UniCredit entities had transmitted USD payments on behalf of sanctioned entities “in a non-transparent manner” through at least one DFS-regulated bank in New York (ie, UniCredit’s correspondent bank). Only three nominal New York ‘touchpoints’ with UniCredit’s own New York branches were asserted by NYDFS:

- One relevant document saved in an electronic file at UniCredit Bank AG’s New York branch;
- 51 payments processed through UniCredit Bank AG’s New York branch, under letters of credit that UniCredit Bank AG had issued for oil exports on behalf of a large European energy company (and its subsidiaries), where the oil was then re-exported to Iran without an OFAC license;
- UniCredit S.p.A.’s New York branch was used to process “impermissible” USD payments on behalf of S.p.A. and UniCredit Bank AG “made pursuant to letters of credit issued by its Home Office”.

NYDFS did not find a connection between the conduct at UniCredit BA and either of the New York branches. Nevertheless, the NYDFS and FRB asserted jurisdiction over the unrelated core conduct at issue (eg, cover payments, stripping, etc.) and found that all three UniCredit entities had conducted business in an unsafe and unsound manner in violation of the New York banking laws.

A REMINDER THAT MULTINATIONAL BANKS MAY FACE CIVIL AND CRIMINAL U.S. EXPOSURE REGARDLESS OF WHETHER THEY HAVE A U.S. BANKING LICENSE

A number of recent resolutions and ongoing public investigations also serve as an important reminder for multinational banks without a U.S. branch that they are not immune to U.S. civil and criminal exposure. While they are not subject to the oversight of U.S. banking regulators, civil and criminal federal authorities may enter the picture where USD transactions are cleared through the U.S. or there is some other U.S. nexus. For example,

in 2014 OFAC imposed a USD9.5 million civil fine on the Bank of Moscow, a bank with no operations, branches or subsidiaries in the United States, for processing payments to, from, or on behalf of sanctioned parties through U.S. correspondent bank accounts. No willful conduct was alleged; rather, OFAC stated that the bank failed to “exercise an appropriate degree of caution or care”. In the past four years, numerous Swiss banks without any U.S. banking operations have reached resolutions with the DOJ’s Tax Division in relation to their U.S. customers abroad. More recently, as set out in the press, a Danish bank is currently subject to investigation by a number of U.S. authorities, including the DOJ and the U.S. Treasury Department, in relation to conduct and transactions originating at its Estonian branch. The basis upon which U.S. authorities are asserting jurisdiction over this matter may be in relation to the USD flows which were cleared through the Danish bank’s U.S. correspondent banks. (Per public reports, there may also be involvement by the U.S. Securities and Exchange Commission. Non-U.S. companies that issue debt or ADRs in U.S. markets may face exposure to regulatory enforcement action under U.S. securities laws in connection with inaccurate disclosures regarding underlying conduct and ongoing investigations.)

A RENEWED NOTE OF CAUTION

Recent AML and sanctions settlements and public investigations highlight the expansive exposure that non-U.S. financial institutions may face for dollar transactions cleared through the United States, a risk that is heightened by the existence of a New York branch.

With the UniCredit resolution, U.S. financial regulators are in uncharted waters, asserting broad authority to assess fines and civil penalties if a non-U.S. bank or any of its affiliates is licensed or regulated by the FRB or the NYDFS – regardless of the strength of the connection between the conduct and the U.S. branch.

Multinational banks licensed in the U.S. (and especially New York), should be vigilant about the various lines of business that touch their U.S. branch. Like UniCredit, they may find worldwide activities scrutinized by U.S. banking regulators even where the U.S. branch does not service those activities.

Moreover, while banks without a U.S. branch are not exposed to U.S. financial regulators, they are not immune to U.S. criminal or civil inquiries for conduct abroad where there are U.S. touchpoints, such as payments cleared through the U.S. ⚠️

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Brexit day 1 readiness for European banks and investment firms: risk, legal and compliance changes for EU firms under EU law

We examine some of the ways in which a hard Brexit will affect the EU legal and regulatory obligations of EU financial services firms facing or using UK clients/counterparties/market infrastructure.

As we near a potential hard Brexit, UK, EU and international banks and investment firms continue to plan for the exit of the UK from the EU single market. From a legal and regulatory perspective, the primary order of change is the loss of passporting. In our experience EU firms are now generally well prepared for this.

Second order issues then follow in two areas. The first is changes to UK legal and regulatory obligations arising from Brexit – these primarily derive from the UK legal and regulatory regime arising from Brexit. The UK authorities have prepared a considerable volume of materials ‘onshoring’ and making various changes to EU law: as a result EU firms with UK branches are generally aware of the UK legal and regulatory changes that will occur on Brexit date and have been putting in place implementation plans. Our experience is that EU firms which provide cross-border services into the UK without a branch are generally a little less well-prepared.

The second is changes to EU legal and regulatory obligations arising from Brexit. Here, unlike in the UK, there is very little legislative change associated with Brexit – the EU has limited itself to the passing of legislation providing limited transitional relief enabling the continued use of UK CCPs and CSDs for a period post-Brexit, and limited changes to EMIR.

Notwithstanding this, the change in status of UK clients, counterparties and market infrastructure from EU to third country status has considerable consequences for the regulatory obligations of EU market participants which deal with them. Further, because (unlike the UK authorities) the EU authorities have largely declined to offer transitional relief associated with those changes in status, a large number of changes will take effect immediately at the point of Brexit.

This paper draws attention to a few of the major areas of change we have identified that will affect EU firms, focusing on EU legal and regulatory obligations. Some, but not all, of those changes could be cured by equivalence decisions from the EU or from competent authorities. The examples below are intended to illustrate that EU firms will have substantial compliance work to do to enable them to meet their – largely unchanged – EU law obligations post-Brexit in connection with activities

which involve the UK. This paper does not purport to give a complete overview of all changes. There are a myriad of further changes which could affect EU firms. Firms should take legal advice on their position.

CREDIT RATINGS AND BENCHMARKS

Use of UK credit ratings and benchmarks. Brexit has the effect that UK credit ratings cease to be eligible for use under the Credit Rating Agency Regulation (including for prudential purposes) unless the credit rating is endorsed in the EEA. Similarly, under the Benchmarks Regulation, following the lapse of the transitional period provided for by the Regulation, benchmarks cease to be eligible for use in the EU unless the relevant benchmark is endorsed, or its administrator recognised, under the Benchmark Regulation. EU firms which are supervised users under the Benchmarks Regulation will need to ensure that UK administered benchmarks they use are eligible from the end of the transitional period.

PRUDENTIAL REQUIREMENTS: CAPITAL REQUIREMENTS REGULATION

Brexit has the effect that UK clients, counterparties, affiliates, securities and market infrastructure cease to benefit from the various preferential prudential treatments afforded to them whilst the UK has been in the EU. Some key examples are as follows:

CCR: exposures to CCPs. From expiry of temporary recognition of the UK CCPs on 31 March 2020 they will cease to be QCCPs and be subject to substantially increased risk weighting requirements for house and client positions.

Risk weighting: standardised approach. Absent an equivalence determination, exposures to UK institutions will become part of the corporate exposure class for credit and counterparty risk, resulting in changes to risk weightings. UK covered bonds will also cease to be eligible as covered bonds and will be risk weighted in the same way as non-covered bonds.

Risk weighting: IRB approach. Under the standardised approach UK sovereign exposures (including to PSEs) will cease automatically to benefit from a 0% risk weight. As a result, under the IRB approach a 0% risk weight will no longer be available. Exposures to UK institutions that

have balance sheet of under EUR70 billion will become subject to an additional 1.25 correlation multiplier under the IRB RWA calculation.

Credit risk mitigation: unfunded CRM: eligibility. UK institutions will become ineligible to provide unfunded CRM.

CVA: affiliate exposures. Derivatives (and in some cases securities financing) exposures to UK affiliates will lose the benefit of the CVA exemption.

Liquidity coverage ratio (LCR). UK covered bonds will cease to have the benefit of preferential treatment for LCR purposes.

DERIVATIVES TRADING: EMIR

Use of UK CCPs. Should the EU not roll over the temporary recognition of UK CCPs (due to end on 30 March 2020) EU firms will cease to be able to receive clearing services from UK CCPs. In addition, EU firms will be unable to discharge the clearing obligation by clearing positions on a UK CCP.

Status of UK exchange-traded derivatives. Absent an equivalence determination UK exchange-traded derivatives will be OTC derivatives at the point of Brexit, with knock-on consequences for counterparty categorisation and the application of the clearing and risk mitigation obligations with respect to such derivatives.

Loss of intragroup exemptions. EU firms which trade derivatives with UK affiliates will lose the benefit of their intragroup exemptions from clearing requirements at the point of Brexit: firms will need to reapply for these.

Loss of pension scheme exemption for UK pension schemes. EU firms which deal with UK pension schemes will lose the benefit of the EMIR exemption for pension schemes.

Loss of preferential status of UK instruments and counterparties under margin requirements. The EMIR margining requirements confer preferential status on EU instruments and counterparties in certain respects. These will cease to apply to UK instruments and counterparties from the point of Brexit. Examples include the (in)eligibility of UK UCITS and of UK banks to hold cash margin.

SECURITISATION: SECURITISATION REGULATION

Ineligibility of UK STS. The Securitisation Regulation introduced a framework for the preferential capital treatment of Simple, Transparent and Standardised (STS) securitisation. UK STS securitisations will not be recognised for purposes of the EU rules, resulting in less favourable capital treatment.

Risk retention. UK investment firms acting as sponsors will not be eligible risk retainers under the EU framework from Brexit.

MARKETS: MiFID II AND MiFIR

Share and derivatives trading obligations. As has been well-flagged, the share and derivatives trading obligations will cease to be capable of being met by trading on UK venues post-Brexit. This issue is compounded somewhat by the dual application of the requirements to UK branches of EU firms.

RETAIL SALES OF FINANCIAL INSTRUMENTS: UCITS AND PRIIPS

Post-Brexit, UK UCITS funds will be treated as alternative investment funds under EU law and fall to the more stringent marketing regime under the Alternative Investment Fund Managers Directive. UK Key Information Documents produced following Brexit will also be ineligible for sales to EU retail investors under the PRIIPS Regulation.

These examples are merely illustrative of the kinds of compliance issues that will arise on day one should the UK leave the EU without a transitional deal agreed. EU firms cannot be complacent. Even though EU law will remain largely unchanged, post-Brexit, there are a myriad of changes which could affect firms. Firms should take legal advice on their position. We stand ready to assist, please call your usual A&O contact or any of the contacts listed &

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A reflection on the current state of play regarding how EEA firms can provide financial services into the UK post Brexit

On 29 October 2019, politicians once again kicked the possibility of a cliff edge Brexit into the grass but with UK politics still deeply divided and a general election on the horizon, it is unlikely that clarity on the Brexit saga will be forthcoming any time before 31 January 2020.

A hard Brexit would result in UK financial services providers losing their rights to provide products and services into the EU. This gives rise to a 'cliff-edge' risk of market disruption as it may become unlawful for UK providers to undertake new business, and potentially even to service existing business, in the EEA. The EU authorities are apparently relaxed about this risk. Contingency planning at the Europe-wide level has been limited to measures permitting continued access by EU market participants to CCPs and CSDs. This has left individual member states to deal with 'cliff edge' concerns through national measures. Our 'hard Brexit law' tracker for each Member State can be found on our Brexit Law website which can be accessed [here](#). On 12 June 2019, the Commission published a communication on the "state of play" of hard Brexit contingency preparations and confirmed that there was no need to amend the substance of any of their existing legislative and non-legislative measures. Whilst the Commission acknowledged that some "residual issues remain" in the context of financial services, there are no plans for any new measures ahead of Brexit.

By contrast, in the UK both the legislator and the regulators have taken extensive action to ensure that EEA firms and other market participants accessing the UK market are provided with a high level of comfort that their access rights will be maintained (for a time limited period), whatever the outcome of the political negotiations.

THE PROPOSED UK REGIME IN THE EVENT OF A HARD BREXIT

Once the EU (Withdrawal) Act 2018 (EUWA) received Royal Assent in June 2018, HM Treasury (HMT) began laying secondary legislation. This not only ensures the UK has a functioning financial services regime (both legislative and regulatory) in the event hard Brexit, but also:

- creates a temporary permissions regime (TPR) enabling passported EU banks, investment firms, payment service providers and investment funds to continue their activities in the UK for a limited period of

time if the UK leaves the EU with no deal and related transitional arrangements;

- provides regulators with the power to grant some flexibility in applying the new requirements under the EUWA (the temporary transitional powers (TTP)). The TTP will allow the regulators to delay, or phase in, regulatory requirements where they change as a result of Brexit or where they apply to firms for the first time; and
- creates a legislative framework to allow those EEA firms that do not enter the TPR, or which exit the TPR without authorisation, to continue servicing existing contracts for a limited period to enable an orderly wind down of their existing business, thereby providing transitional relief in respect of the so-called 'contractual continuity' issues associated with the loss of passporting rights.

An overview of all options available to EEA firms accessing the UK market can be found [here](#). This summary includes a review of the mechanics for gaining entry to the TPR, the regulators proposed approach to transitional relief – bar certain prescribed areas, both the FCA and PRA are (broadly) looking to postpone the application of onshoring (that is, amendments to rules and legislation made using powers under the EUWA) changes to firms' obligations until 31 December 2020 (this date may be subject to change given the article 50 extension to 31 January 2020) and an overview of the approach each regulator will take in applying the rule-set to TP firms, subject to the application of the TTP.

In terms of what rules apply to firms in the TPR, each regulator has taken a different approach, which will make implementation particularly challenging in those areas where common requirements are currently applied by both regulators. The FCA has proposed a highly detailed set of rules determining the application of its regulatory ruleset to TPR firms, whereas the PRA proposes a more straightforward approach, based on the application of its rules for third country firms from the point firms enter into the TPR. In summary:

- the FCA generally proposes only to preserve those requirements which implement EU directives; the PRA has chosen to apply its rules generally;
- the FCA is offering substituted compliance for those rules which implement EU directives; the PRA is not; and
- the FCA has sought to preserve the application of existing rules which are deleted at the point of Brexit; the PRA has not.

This difference in approach is considered further in the article linked above. We have produced a toolkit enabling firms which conduct wholesale business into the UK to identify how the PRA and FCA rules would apply to them on entry into the TPR on a hard Brexit, and on exit from the TPRs. Further information about the toolkit is available [here](#).

WHAT HAS CHANGED OR IS LIKELY TO CHANGE DURING THIS EXTENDED ARTICLE 50 TIME PERIOD?

TPR notifications

On 30 October 2019, the FCA confirmed the deadline for notifications for the TPR would be extended to 30 January 2020. Fund managers will have until 15 January 2020 to inform the FCA if they want to make changes to their existing notification. As regards incoming EEA credit institutions and insurers, the PRA confirmed back in April, at the time of the second extension, that it would not be extending the window further to take account of the revised timeline.

Inflight legislation

The UK government had intended to legislate to clarify the status of “in-flight” EU financial services legislation. For these purposes, “in-flight” legislation referred to:

- EU legislative measures that had been adopted by the EU, but did not yet apply and so did not fall within the scope of the EUWA; and

- Legislative proposals that were currently in negotiation and may be adopted up to two years post Brexit.

The Financial Services (Implementation of Legislation) Bill stalled during its Parliamentary process and then fell when Parliament was prorogued on 8 October 2019. To the extent hard Brexit takes place on 31 January 2020, a new bill would have to be introduced into Parliament to ensure (for example) that elements of the EU risk reduction package (including under CRDV) are brought into the UK statute book as they will not be onshored under the EUWA.

WHAT AREAS REMAIN OUTSTANDING?

A key outstanding issue that has garnered a lot of attention during each extension to the article 50 timeline regards trading venues and the lack of equivalence determinations by either the UK or the EU. On a hard Brexit, UK venues will no longer be considered European venues for the purposes of MiFID II and will instead be third country trading venues. Likewise, in the UK onshoring of the MiFID II legislation, European venues will be third country trading venues. This has significant ramifications in the context of both the share and derivatives trading obligations under MiFID II.

Whilst the FCA have stated (in the context of the share trading obligation) that in the absence of reciprocal equivalence, they stand ready to “engage constructively” with ESMA and other European authorities to find a time limited solution to mitigate disruption (until longer term solution are found), it is clear that recognition of trading venues on either side of the channel is a political pawn in the Brexit game.

In relation to the derivatives trading obligation, focus has centred on the overlapping obligation arising under EU and onshored MiFIR with proposals being put forward by the French regulator to try and ensure a workable solution is available in the event of a hard Brexit 🇬🇧

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