Davis Polk

The Financial Services and Markets Act 2023 ushers in an era of major regulatory change in the UK

July 20, 2023 | Client Update | 10-minute read

On 29 June 2023, the Financial Services and Markets Act 2023 received royal assent. It represents one of the most important pieces of legislation for the United Kingdom's financial services sector in years.

The Financial Services and Markets Act 2023 (FSMA 2023) makes significant changes to the framework for financial services regulation to reflect the United Kingdom's (UK) position outside of the European Union (EU). In addition to implementing the outcomes of the Future Regulatory Framework Review, the FSMA 2023 seeks to enhance the UK's position as a leading financial hub by reforming the capital markets regime, bringing stablecoins that are used as a form of payment into the scope of regulation and amending the objectives of the financial services regulators to include advancing the international competitiveness and medium to long-term growth of the UK economy.

In this briefing we focus on four key aspects of the FSMA 2023: (i) the revocation of retained EU law as it relates to financial services regulation; (ii) the establishment of a new Designated Activities Regime; (iii) conferring powers on UK regulatory authorities to designate and oversee the activities of critical third parties that provide services to financial firms; and (iv) the introduction of a new regulatory gateway for approving the financial promotions of firms that are not authorised by a UK regulatory authority.

Revocation of retained EU law

A significant proportion of the UK's current regulatory framework derives from EU law, much of which was enacted in response to the 2008/09 financial crisis. When the UK formally exited the EU, that body of EU law was incorporated into UK law by the European Union (Withdrawal) Act 2018 (as amended) and is referred to as retained EU law. The purpose of that onshoring exercise was to ensure the UK continued to have a stable legal and regulatory framework in place after leaving the EU. Retained EU law has been subject to extensive, largely technical, amendments in order to correct any deficiencies arising from the fact that the UK is no longer a member of the EU.

Section 1 of the FSMA 2023 revokes a long list of retained EU law as it relates to financial services. This includes EU regulations and directives, delegated regulations and implementing acts, UK subordinate legislation that gives effect to EU measures and parts of UK primary legislation. The full list is set out in Schedule 1 of the FSMA 2023. Among the more noteworthy pieces of retained EU law being revoked is the Prospectus Regulation, the Market Abuse Regulation, the Capital Requirements Regulation and the Markets in Financial Instruments Regulation. Retained EU law which has been incorporated into the rulebooks of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) will not be revoked by the FSMA 2023. Instead, these rules can be updated by the regulators themselves in accordance with their normal processes set out in the Financial Services and Markets Act 2000 (as amended) (FSMA 2000).

Copyright 2023 Davis Polk & Wardwell LLP

The explanatory notes published at the time the Financial Services and Markets Bill was introduced in Parliament states that the government's overall policy objective in repealing retained EU law as it relates to financial services is to establish a "comprehensive FSMA model" for financial services regulation. The FSMA model refers to the existing regulatory system pursuant to which the PRA and FCA are responsible for setting regulatory standards applicable to regulated firms within a framework and according to a set of objectives established by Parliament and the government. The end result of moving to a comprehensive FSMA model is that a large number of regulatory requirements that currently derive from retain EU law will, following a process of consultation and refinement, generally move to the rulebooks of the UK regulators.

Given the scale and complexity of the task, the revocation of retained EU law will occur in stages and is likely to take a number of years. It is expected that individual pieces of retained EU law will not be revoked formally until such time as new rules are put in place by UK regulatory authorities. The government's policy position is to prioritise reform of legislation "where there is the greatest opportunity for beneficial reform". The priority review categories include Wholesale Markets, Listing, the Securitisations Regime and Solvency II. Regulators have already begun consulting on new rules in each of these areas and in some cases draft secondary legislation has also been published, for example, The Public Offers and Admissions to Trading Regulations 2023 and The Securitisation Regulations 2023.

Designated activities regime

Under the UK's existing regulatory framework, persons are prohibited from carrying on certain regulated activities by way of business in the UK unless they are authorised to do so by a UK regulator or are able to rely on an exemption. This is referred to as the general prohibition. The types of regulated activities that are subject to an authorisation requirement are contained in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended) (the RAO). Regulated activities include dealing as principal and agent, arranging deals in investments, advising on investments and managing investments.

However, there are a number of activities relating to financial markets that are currently subject to regulation under retained EU law that do not require authorisation. Such activities include listing shares on an exchange, entering into a derivative contract for commercial hedging purposes and short selling. It is important that these activities continue to be subject to regulation after retained EU law is revoked. But the government's view is that bringing these activities within the current regulated activities framework in the RAO would be disproportionate and inappropriate.

To fill the gap in regulation once retained EU law is revoked, the FSMA 2023 creates the designated activities regime (DAR). The DAR is a new regulatory regime for activities that do not require prior authorisation but which are subject to certain regulatory requirements. The FSMA 2023 grants HM Treasury the power to determine the activities that fall within the scope of the DAR. In addition, when designating an activity HM Treasury may make regulations relating to the performance of that activity, including prohibiting the activity in its entirety. The FCA may also make rules relating to designated activities where this has been provided for by HM Treasury. Where an activity has been designated, anyone carrying on that activity will be required to follow the rules for that particular activity unless they are able to rely on an exemption.

The FSMA 2023 inserts a new Schedule 6B into the FSMA 2000 which contains examples of activities that may be specified as designated activities, although nothing in the new Schedule 6B limits the powers conferred on HM Treasury to determine the scope of the DAR. Some of the examples of activities that may fall within the DAR include offering securities to the public, applying for, securing or maintaining the admission of securities to trading on a securities market, issuing an instrument which references a benchmark and holding positions in commodity derivatives. The recently published draft version of The Public Offers and Admissions to Trading Regulations 2023 has additional examples of activities that HM Treasury intends to specify for the purposes of the DAR, such as, communicating an advertisement relating to an offer of relevant securities to the public and admitting transferable securities to trading on a primary MTF.

Critical third parties

Regulated financial services firms and financial market infrastructures (e.g. clearing houses, exchanges, CSDs, etc.) are increasingly outsourcing important services to third parties that sit outside the regulatory perimeter. Although the FCA, PRA and Bank of England have powers enabling them to take action in order to mitigate serious risks to the UK financial system, these powers generally apply only to firms that are subject to regulation. The same is true of the detailed rules relating to outsourcing arrangements; that is, the rules impose direct obligations on regulated firms which, in turn, are

Copyright 2023 Davis Polk & Wardwell LLP

expected to impose various requirements on their unregulated service providers through contract. The use by financial services firms of a relatively small number of providers to deliver important services raises systemic risk concerns which the existing regulatory framework does not adequately manage.

For that reason, the FSMA 2023 inserts new provisions in the FSMA 2000 which grant HM Treasury the power to designate a person that provides services to one or more authorised persons, e-money or payment services firms or financial market infrastructures, as a "critical third party". Designation is permitted where, in the Treasury's opinion, a failure or disruption relating to the provision of services by the relevant third party could threaten the stability of, or confidence in, the UK financial system. HM Treasury must have regard to the materiality of the services provided by a third party and the number and type of firms which use the third party's services. Prior to designating a critical third party, HM Treasury must consult with the FCA, PRA and the Bank of England and give written notice to the person being designated specifying a reasonable period within which the person may make representations in relation to the Treasury's proposal.

Once designated as a critical third party, a firm will be subject to rules made by the FCA, PRA or Bank of England, as well as information gathering and limited enforcement powers. The primary purpose of the rule-making powers granted to the FCA, PRA and Bank of England is to enable them to introduce minimum resilience standards and resilience testing that applies directly to critical service providers. This is in line with the FCA, PRA and Bank of England joint Discussion Paper published in July 2022 which sets out how the regulators could use their new powers to assess and strengthen the resilience of services provided by critical third parties. We expect there will be more detailed consultations on the content of the rules for critical third parties in the near future.

Financial promotion gateway

Section 21 of the FSMA 2000 provides that a person must not, in the course of business, communicate an invitation or inducement to engage in an investment activity (e.g. buying and selling securities) unless that person is (i) authorised under the FSMA 2000 (i.e., an authorised person), (ii) the content of the communication is approved by an authorised person in accordance with the rules of the FCA, or (iii) the communication is exempt. It is a criminal offence for an unauthorised person to communicate a financial promotion in breach of section 21 of the FSMA.

In the context of capital markets transactions, it is relatively common for a bank, often acting as an underwriter, to approve certain financial promotions that are to be communicated by an issuer that is not itself authorised. Under the current UK regime, any authorised firm can approve any financial promotion of an unauthorised firm. There is no requirement for the authorised firm to have any particular expertise or familiarity with the product or activity to which the financial promotion that it is approving relates. This has led to concerns that consumers may suffer harm due to financial promotions not being appropriately scrutinised or understood by the authorised firms approving them.

To address this concern, the FSMA 2023 introduces a new regulatory gateway which authorised firms must pass through before being able to approve financial promotions for unauthorised firms. Authorised firms intending to approve the financial promotions of unauthorised firms must first obtain specific permission from the FCA. Firms that are already authorised must apply for a variation of their permissions to include the ability to approve the financial promotions of unauthorised firms while firms applying for new authorisations will need to specify that they wish to obtain this new permission. In both cases, firms must request in their applications whether permission is being sought in relation to the approval of specific types of financial promotions or for financial promotions generally under section 21 FSMA. The FCA will be able to place restrictions on the types of financial promotions firms will be able to approve, which may be narrower than that requested in a firm's application. It is hoped that the gateway will improve the quality of financial promotions for the benefit of customers while also giving the FCA greater oversight and control over the process of approving financial promotions for unauthorised firms.

Although firms will need to prepare applications and relevant supporting documentation in order to pass through the gateway, it is unlikely that the new regime will cause significant practical difficulties for larger firms that already routinely approve financial promotions. Many of these firms have robust internal processes in place that must be followed in order to approve the financial promotions of unauthorised firms. It is likely that, as the result of these changes, there will be fewer firms that approve the financial promotions of unauthorised firms and those firms that successfully pass through the gateway will be subject to greater regulatory scrutiny

Timing

Copyright 2023 Davis Polk & Wardwell LLP

Provisions of the FSMA 2023 enter into force either: (i) on 29 June 2023 (i.e., the day it received royal ascent); (ii) 29 August 2023; or (iii) on a later date specified by HM Treasury. At the time of writing, the Financial Services and Markets Act 2023 (Commencement No. 1) Regulations 2023 provide that the DAR and critical third party-related provisions are due to enter into force on 29 August 2023.

Future of UK Capital Markets series

Visit our **Future of UK Capital Markets** page to read our series of client updates on the UK government's sweeping efforts to reform the capital markets and the wider regulatory system to strengthen the UK's position as a leading global financial centre.

Copyright 2023 Davis Polk & Wardwell LLP

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Will Pearce
+44 20 7418 1448
will.pearce@davispolk.com

Simon Witty
+44 20 7418 1015
simon.witty@davispolk.com

Mark Chalmers
+44 20 7418 1324
mark.chalmers@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.

Copyright 2023 Davis Polk & Wardwell LLP