Financial Services Compliance 2020

Contributing editor
Annette L Nazareth
Davis Polk & Wardwell LLP

LEXOLOGY®
Getting The Deal Through

Davis Polk

Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development manager
Adam Sargent
adam.sargent@gettingthedealthrough.com

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The Deal Through is delighted to publish the 16th edition of *Financial Services Compliance*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on the Netherlands.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Annette L Nazareth of Davis Polk & Wardwell, for her continued assistance with this volume.

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Introduction

Annette L Nazareth
Davis Polk & Wardwell LLP

A well-designed and effectively implemented financial services compliance regime is the foundation of a stable, transparent and fair marketplace. While regulation and compliance are, by definition, key areas of focus for supervisory authorities, refining and updating those requirements in an evolving environment – one increasingly characterised by new technologies, market players and products – poses heightened challenges. Supervisors have been grappling with emerging regulatory issues, both at a national level and through international bodies such as the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO). Highlights of the regulatory initiatives of the past year include those relating to cyber risks, digital assets, financial innovation and retail investor issues.

Cyber risks

Cybersecurity risk is a key vulnerability to the financial system and it continues to be an area of significant focus by regulators. Indeed, concerns have escalated that financial systems are not only a target of cybercriminals, but also of state actors due to recent geopolitical events. Earlier last year, the FSB published a progress report on its work related to developing effective practices for financial institutions to respond to, and recover from, cybersecurity incidents. Among other methods to enhance cyber resilience, the FSB is developing a toolkit of effective practices for financial institutions. Similarly, IOSCO focused its efforts on cybersecurity risks in 2019. It issued a final report that provided an overview of three internationally recognised cyber standards and frameworks used by IOSCO members. It also identified potential gaps in the application of these standards and sought to promote sound cyber practices by IOSCO members. Members of the US Congress have called upon the US financial regulators to take all necessary precautions to protect the financial system from cybersecurity vulnerabilities. Even financial regulators have been subject to cyberattacks, as evidenced by the breach of the US Securities and Exchange Commission's (SEC) EDGAR system in 2016.

Technological innovations

Digital assets and blockchain-based technologies continue to command the attention of regulators across the globe. Technological innovation in the financial sector offers large potential benefits, including greater opportunities for disintermediation, efficiency and inclusiveness. These opportunities also raise challenges. Regulators are keenly focused, for example, on a number of issues raised by the emergence of digital assets, such as investor protection, market integrity, transparency, conflicts of interest, financial crime and potential financial stability implications. In 2019, the FSB turned its attention to analysing and assessing the regulatory and financial stability implications of global stablecoins (cryptocurrencies pegged to another cryptocurrency, fiat money or exchange-traded commodities), a topic that garnered significant attention with Facebook's announcement that it planned to introduce the Libra stablecoin. New entrants in the financial system, such as fintech firms and large technology companies, also are altering the regulatory landscape and challenging traditional notions of the perimeters of regulation.

Progress on the trading of digital assets that are securities has begun to slow in the US due to regulatory issues raised by the SEC. Over the past several years, the SEC has made clear that firms effecting transactions in digital assets that are securities may need to register with the SEC as broker-dealers, and those operating trading platforms for such assets must operate as national securities exchanges or broker-dealer alternative trading systems. SEC staff raised issues in 2019, however, about how a broker-dealer can satisfy its regulatory obligations to safely hold digital asset securities in custody when those securities are represented on a blockchain. Until such time as the SEC staff becomes comfortable with the implications of blockchains for digital asset security custody, it will only permit broker-dealers to engage in digital asset securities activities if the broker-dealer does not have custody or control over the customer's digital asset securities. This "go-slow and study" position of the SEC's staff, which is symptomatic of the desire of regulators to better understand evolving technological changes before they act, has had discernible market impact in slowing the development of this space.

In recent guidance, the Financial Stability Oversight Council (FSOC) has signalled how regulators may approach the risks to financial stability from digital transformation. FSOC, a body comprised of US financial regulators and chaired by the US Treasury Secretary, was created by statute in the wake of the 2008 financial crisis. It has authority to designate non-bank financial companies as systemically important, which would subject them to heightened regulation by the Federal Reserve. FSOC also is authorised to issue recommendations to financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practices that could create or enhance certain systemic risks. In the past, FSOC has relied more heavily on its designation authority of particular non-bank financial companies, but new guidelines FSOC issued in 2019 indicate that it will prioritise its efforts to identify, assess and address potential risks and threats to US financial stability through an activities based approach. Under this approach, FSOC will identify and address, in consultation with relevant financial regulatory agencies, potential risks and emerging threats on a system-wide basis. FSOC noted in its guidance that the issues of greatest concern are often identified in its annual reports. Some areas identified in FSOC's most recent annual report include cybersecurity, financial innovation (including stablecoins), and payment systems (including payments made through use of a blockchain). FSOC is likely to focus significant attention on these areas in the future, given its concerns regarding the potential systemic risk implications to the financial system and the broader economy of widespread adoption of these products and activities. FSOC also expressed in its annual report concerns about the evolving market for digital assets, particularly since digital asset networks can be international and include a diverse set of nonfinancial, and thus unregulated, entities. Finally, it noted that large technology and e-commerce companies providing financial services may increasingly compete with incumbent financial service providers that are subject to regulations that do not apply to the new entrants. All

of these statements presage a greater focus on regulating new financial products and activities, particularly those related to digital assets and blockchain technology, through its activities based regulatory authority.

Retail investor protection

Investor protection is always a cornerstone of any financial regulatory regime. In the US, after nearly two decades of study and debate, the SEC, under its new Regulation Best Interest (Reg BI), imposed a new standard of conduct for broker-dealers when recommending a securities transaction or an investment strategy to a retail customer. Reg BI requires broker-dealers to act in the "best interest" of a retail customer when making a recommendation and not place their own financial or other interests ahead of the customer's interest. Previously broker-dealers were only required to ensure that a recommended investment was suitable for the customer.

Reg BI has four component compliance obligations applicable to the broker-dealer:

- a disclosure obligation;
- a care obligation;
- a conflict-of-interest obligation; and
- a compliance obligation.

A broker-dealer may continue to engage in many traditional broker-dealer activities that are impermissible under a fiduciary duty standard, provided it complies with the four component obligations of Reg BI. Examples of activities this would include are:

- engaging in principal trading for the broker-dealer's own account;
- engaging in a transaction with a customer in which the broker is acting in a principal capacity;
- recommending its proprietary products to customers; and
- charging commissions.

The best-interest standard is thus similar, but not identical to, the fiduciary duty standard applicable to investment advisers.

The SEC also will now require broker-dealers and investment advisers to provide retail customers with a new Form CRS, which is a short relationship summary document that provides information about the firm and the services it provides, including fees and costs, conflicts of interest, and any disciplinary history relating to the firm's financial professionals. Given the breadth of the compliance changes resulting from Reg BI and Form CRS, significant efforts are underway by broker-dealers in the US to meet the compliance deadline of 30 June 2020.

Investor education and protection are also key components of IOSCO's mission. In 2019, securities regulators, stock exchanges, international organisations, investor associations and other IOSCO stakeholders from more than 90 jurisdictions participated in an IOSCO World Investor Week to foster financial literacy and investor education and protection. The topics on the programme ranged from the fundamentals of smart investing to online investments, digital assets and initial coin offerings. Also in 2019, IOSCO published the Core Competencies Framework on Financial Literacy to assist IOSCO members, investor education providers and others in their efforts to develop and implement investor education initiatives. The objective of the Framework is to better prepare investors to navigate the complex investing environment. It focuses on the core competencies that would enable investors to make informed decisions about their investments. IOSCO also published a report that reviewed IOSCO member efforts to deter mis-selling of complex financial products. All of these efforts evidence a strong international commitment to protect and educate retail investors.

This edition of *Financial Services Compliance 2020* is a compilation of the rules and approaches to financial services compliance in each of the major jurisdictions and the European Union. Our hope is that this very practical and pragmatic guide will assist lawyers, compliance professions, boards of directors and others who represent or are engaged with globally active institutions in navigating the regulatory requirements and frameworks of multiple jurisdictions. Understanding the regulatory landscape and the differences in approaches is fundamental to successful transactions in financial commerce across borders. Each chapter of this guide has a common set of questions, allowing readers to deepen their understanding of a single jurisdiction, or to understand how any particular issue or product would be treated across a number of geographies. Importantly, the authors of each chapter are leading authorities on financial services regulation in their respective jurisdictions. Each author has practical experience in the details of his or her jurisdiction, which makes this volume important for globally active firms, regional institutions and purely national market participants.

European Union overview

Mark Chalmers, Jennifer Duffy and Simon Witty
Davis Polk and Wardwell London LLP

Introduction

Since the 2008 financial crisis, there has been a pronounced shift towards concentration of power and influence at the European Union level, away from the regulators in individual member states. In addition, new laws and initiatives at the EU level have tightened regulation of investment banking activities, and the securities and derivatives markets.

Until recently, most EU financial laws were effected through directives, which are not directly applicable and must be implemented into the national law of EU member states. Following the crisis, the primary vehicle for financial services rulemaking has been EU regulations. Such regulations are directly applicable without the need for transposition into national law. As a consequence, the scope for member state discretion in setting and interpreting key regulations has been reduced.

Following a number of years in which successive eurozone banking crises dominated the attention of market participants and regulators, Brexit is now a key factor in the development of new legislation and regulation.

The EU financial services regulatory architecture

Financial services legislation follows the standard legislative procedure, whereby the European Commission (the Commission), the Council of the European Union and the European Parliament work through various compromise proposals to achieve a final text. The process typically takes at least 12 months, and may drag on for years if the proposed legislation is complex or controversial.

The Lamfalussy process

EU financial services rules usually comprise of a package of different types of legislation and guidance. This approach, named after a senior EU official, Alexandre Lamfalussy, proceeds as follows:

- Level 1: framework legislation in the form of a regulation or a directive setting out the general requirements of the initiative. Individual provisions in that legislation empower the Commission to adopt Level 2 measures.
- Level 2: detailed implementing legislation, usually but not always in the form of a regulation, drafted in the first instance by one of the European Supervisory Authorities (ESAs).
- Level 3: guidance for national regulators prepared by the ESAs. National regulators adopt this guidance on a 'comply or explain' basis.
- Level 4: supervision and enforcement practice, usually by national regulators.

European Supervisory Authorities

Following the financial crisis, the EU institutions concluded that the former committees of national regulators that had been formed to assist in the supervision of cross-border activity had insufficient powers and influence. In response, the EU created a new European System of Financial Supervisors, comprising of the following ESAs:

- the European Banking Authority, based in Paris;
- the European Insurance and Occupational Pensions Authority, based in Frankfurt; and
- the European Securities and Markets Authority (ESMA), based in Paris.

Although the ESAs do not generally have direct oversight of individual EU firms (except ESMA which overseas credit rating agencies), they have a number of important powers and duties in relation to EU financial regulation, including:

- the development of binding technical standards in relation to Level 1 legislation (although the Commission actually adopts the standards as Level 2 legislation);
- dispute resolution between national regulators;
- ensuring the consistent application of EU rules by national regulators, including through the issuance of Level 3 guidance and more informal 'Q&A' documents for certain legislation; and
- in 'emergency situations', the power to intervene directly in the supervision of individual EU firms, or direct national regulators to take certain actions, or both.

Key EU financial services legislation

MiFID II

On 3 January 2018, the recast Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together known as 'MiFID II') legislative package replaced the original MiFID. MiFID II is the most important piece of EU regulation covering investment banking and securities markets. MiFID-regulated services include many of those necessary to provide broker-dealer or corporate finance-type services, such as underwriting of financial instruments, reception, execution and transmission of orders, and the provision of investment advice. MiFID II covers, among other things:

- The authorisation of investment firms.
- The availability of a passport to allow investment firms established in EU member states access to the markets of another member state, without being required to set up a subsidiary or a branch and obtain a separate licence to operate as an investment firm in that member state.
- Detailed conduct-of-business rules in relation to investment services and activities, including the reception and transmission of orders, managing investments, the provision of investment advice, underwriting and placing of securities. This has been expanded under the new MiFID II regime to include new rules on conflicts of interest, best execution, product governance, receipt of inducements by asset managers and transparency in relation to mandate and instructions.
- A customer classification regime, dividing clients into 'eligible counterparties', 'professional clients' and 'retail clients'. Certain conduct-of-business rules are modified or disapplied in respect of business with professional clients and eligible counterparties.

- The regulation of securities trading venues in the EU, divided into regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs), with different levels of regulatory requirements applying to each.
- A detailed and complex pre- and post-trade transparency regime applicable to securities traded on those markets.
- Rules for systematic internalisers (major traders on a principal basis) obliging them to make public the prices at which they are willing to trade in securities.
- Requirements for algorithmic and high-frequency trading.
- A trading requirement for certain categories of sufficiently liquid derivatives, so that all EU trading in such derivatives must occur on a regulated market, MTF or OTF.
- Position limits and reporting for commodity derivatives and new powers for national regulators to intervene in the trading of commodity derivatives.
- New powers for national regulators to ban specific investment products or services in certain circumstances.
- A 'passport' for non-EU firms to provide services into the EU in certain circumstances, subject to an equivalence determination by the Commission in respect of the relevant non-EU country and cooperation agreement in place between the non-EU regulator and ESMA.

The Benchmarks Regulation

From 1 January 2018, a new regulation, the Benchmarks Regulation (BMR), has applied to the use of, contribution to and administration of indices used as financial benchmarks in the EU.

The Commission published its original proposal for the BMR in 2013, following the settlements reached by regulators with a number of banks concerning the manipulation of the LIBOR and EURIBOR interest rate benchmarks. The Commission aimed to protect investors and consumers and limit the risks of future manipulation by improving how benchmarks are produced and used (it has been estimated that contracts worth at least US$300 trillion reference LIBOR alone).

The BMR consequently defines 'benchmark' widely so it includes interest rate benchmarks, commodity benchmarks and bespoke strategy indices, among other things. Administrators are caught by the BMR where indices they produce are referenced in EU-traded instruments or EU-regulated consumer loans or mortgages, and where they are used by EU investment funds to measure performance.

The BMR imposes an authorisation requirement for EU benchmark administrators, in addition to conduct and governance requirements. Most of the BMR's provisions have applied from 1 January 2018 and EU administrators providing benchmarks in the EU must have applied for authorisation under the BMR by 1 January 2020. The transitional deadline for critical and third-country benchmarks to become compliant with the BMR has been extended to 31 December 2021.

The European Market Infrastructure Regulation

Following the financial crisis and the emergence of an international consensus at G20 level, the EU introduced the European Market Infrastructure Regulation (EMIR) to increase transparency in the financial markets. EMIR provides for:

- The prudential regulation of central clearing counterparties (CCPs), including requirements for authorisation, capital, margins, organisational rules and the establishment of a default fund.
- A reporting obligation in respect of all derivatives (not just over-the-counter (OTC) derivatives) entered into by all EU counterparties, including CCPs, to registered or recognised trade repositories. ESMA is responsible for the registration and supervision of these trade repositories. The reporting obligation has been in place since February 2014. In practice, counterparties have opted either to set up a direct relationship with a trade repository or to establish delegated reporting arrangements with their counterparty or a third-party provider. A trade repository must register with ESMA if it wishes to receive and process reports in accordance with EMIR. Once registered, the trade repository is able to receive reports from counterparties across the EU.
- A clearing obligation applicable to categories of standardised derivatives that meet criteria set out in EMIR Level 2 legislation. This obligation applies to certain EU 'financial counterparties' and EU 'non-financial counterparties' whose trading exceeds a specified threshold. This obligation also applies to certain non-EU counterparties in specified circumstances. ESMA and the Commission decided to phase in the application of the clearing obligation depending on the EMIR categorisation of counterparties and the size of their trading activities. The clearing obligation for the most commonly used interest rate swaps denominated in euros, sterling, yen and US dollars began for 'Category 1' firms in 2016 with a phased introduction for other types of counterparty until 21 December 2018. A similar approach has been adopted for certain credit derivative swaps (CDS), with a phase-in period which ran until 9 May 2019.
- The risk mitigation obligations are designed to reduce risk for OTC contracts that are not subject to the clearing obligation, including contractual requirements around portfolio reconciliation and dispute resolution, and a requirement for exchanges of collateral (margin) for certain categories of OTC derivatives. EMIR Level 2 legislation provides for an obligation on counterparties that are in scope (mostly financial counterparties and other counterparties that carry out substantial levels of derivatives trading) to exchange initial and variation margin when dealing with each other. It also sets out a list of eligible collateral for the exchange of collateral and the criteria to ensure that it is sufficiently diversified. EMIR also requires operational procedures relating to margin to be put in place by the counterparties, such as legal assessments of the enforceability of the arrangements for the exchange of collateral.

EMIR was amended during 2019 by the introduction of EMIR 2.2 and the EMIR REFIT Regulation.

EMIR 2.2 – a regulation amending the supervisory regime for CCPs under EMIR, which came into force on 1 January 2020 – amended, among other things, the procedures involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs. The aim is to address challenges in derivatives clearing as it grows in scale and seeks to reflect a pan-European approach to the supervision of EU and non-EU CCPs, to ensure further supervisory convergence and to enable closer cooperation between supervisory authorities and central banks in the EU and in non-EU countries.

The EMIR REFIT Regulation, which entered into force on 17 June 2019, amends EMIR primarily to simplify certain requirements, address transparency issues and reduce disproportionate costs for smaller counterparties to OTC derivatives trades. In particular, it introduces a new category of "small financial counterparties" which will be exempted from the obligation to clear their transactions through a CCP, while remaining subject to risk mitigation obligations, including margin requirements. Smaller non-financial counterparties will also have reduced reporting obligations.

The Short Selling Regulation

The EU regulation on short selling and certain aspects of credit default swaps took effect on 1 November 2012 and sought to harmonise the short-selling rules across the EU. The key elements of the Regulation include:

- transparency requirements in relation to short positions in shares traded on an EU venue and EU sovereign debt and those with CDS positions in relation to EU sovereign debt issuers, including the flagging of short orders;

- a ban on 'naked' short selling – entering into a short sale of EU sovereign debt or shares trading on an EU venue without having borrowed, or entered into an agreement to borrow, the relevant financial instruments;
- disclosure of short positions to national regulators once a short position in the relevant instruments reaches 0.2 per cent, and disclosure to the relevant market once the position reaches 0.5 per cent, of the issuer's share capital; and
- national regulators may impose temporary bans on short selling and related derivative transactions of up to three months in some emergency circumstances.

The Market Abuse Regulation

Since 3 July 2016, the Market Abuse Regulation (MAR) has applied across the EU, replacing the previous market abuse regimes that existed in member states and applied only to instruments traded on EU-regulated markets.

Under MAR, the EU market abuse regime also applies to issuers with financial instruments, such as debt securities, admitted to trading (or for which a request for admission to trading has been made) on an MTF or an OTF. MAR also applies to derivatives or other instruments whose price or value depends on, or has an effect on, the price of certain financial instruments, regardless of where or whether those related instruments are traded. This last category of instruments widens the scope of MAR further, to include instruments traded outside the EU that could have a price effect on the instruments admitted to trading on an EU trading venue.

As a result, MAR prohibits insider dealing, unlawful disclosure of inside information and market manipulation in respect of a much wider range of securities in a much wider range of circumstances. The regime also provides for a range of obligations on issuers and, in certain cases, those institutions who act on their behalf.

Key issuer obligations under MAR include the following.

Disclosure of inside information

An issuer with securities (debt or equity) admitted to trading on an EU venue must disclose inside information to the market as soon as possible, except where it is in the issuer's legitimate interests to delay disclosure. Under MAR, this disclosure obligation applies to a much wider range of instruments than previously. MAR also requires an issuer to inform the national regulator of the trading venue of any such delay, and issuers must also retain a record of how they determined that the delay in disclosure was in their legitimate interests. In addition, MAR provides that, once disclosed, inside information must be available to the public on the issuer's website for five years.

Insider lists

MAR also requires an issuer to maintain, in a prescribed format, 'insider lists' detailing those persons working for it (either inside or outside the business) who have access to inside information relating directly or indirectly to it.

PDMR dealings

MAR requires persons discharging managerial responsibilities (PDMRs), and persons closely associated with them, to disclose to the issuer and the national regulator certain notifiable transactions in the issuer's financial instruments. The issuer must ensure that any such notification is also disclosed to the EU market. In addition, MAR generally prohibits PDMRs from dealing when in possession of inside information or in a 'closed period', namely 30 days before an announcement of interim or annual results.

Market soundings

Under MAR, a market sounding comprises of the communication of information, prior to the announcement of a transaction, to gauge the interest of potential investors. Where sounding-out investors involves disclosure of inside information, the issuer can benefit from a 'safe harbour' where it follows a specific market sounding procedure and maintains certain records. Although the clear policy focus of the market soundings regime is on the selective disclosure of inside information, a market sounding can also encompass situations where no such disclosure occurs prior to the announcement of a transaction (eg, in a roadshow where only public information is disclosed).

The Acquisition Directive

The Acquisition Directive provides for a harmonised regime for the acquisition of control in financial firms (including investment firms, banks and insurers) in the EU. Persons wishing to acquire control in such firms must seek prior regulatory approval before completion. 'Control' for these purposes is defined as being 10 per cent or more of the share capital or voting rights in the relevant firm or in any parent undertaking. The Acquisition Directive also contains provisions providing that where parties are acting in concert with one another, their interests will be aggregated for the purposes of the control threshold.

The CRD IV package

In the EU, the principal regulation of the banking sector is contained in the Capital Requirements Directive and the Capital Requirements Regulation (together known as the CRD IV package). The legislation sets out, among other things:

- an authorisation regime for 'credit institutions' (broadly, deposit taking entities);
- prudential rules for banks and larger investment firms on a solo and consolidated basis, including detailed rules around capital requirements, including capital ratios;
- passport rights for credit institutions across the EU;
- liquidity standards in the form of a liquidity coverage ratio;
- rules on capital conservation and counter-cyclical capital buffers, to be maintained in addition to minimum regulatory capital requirements;
- rules on counterparty credit risk;
- rules on corporate governance and risk management; and
- remuneration limits and disclosure requirements (including a 'bonus cap' whereby the variable remuneration of certain bank staff (senior managers, material risk takers and certain compliance staff) is limited to 100 per cent of their fixed remuneration or to 200 per cent, with shareholder approval).

As discussed below, the banking reform package which amends the CRD IV framework was adopted in 2019. However, it is subject to various transitional and staged timetables, with most provisions expected to apply from mid-2021.

The Alternative Investment Fund Managers Directive

The Alternative Investment Fund Managers Directive (AIFMD) regulates the authorisation, operations and transparency of managers of alternative investment funds (AIFMs) who manage or market funds in the EU. The scope of the AIFMD is wide and regulates the provision of risk management and portfolio management services in relation to an alternative investment fund (AIF). The definition of an AIF is very broad and includes a wide range of structures and fund types. Both open-ended and closed-ended vehicles and listed and unlisted vehicles can be AIFs, as can investment structures not typically thought of as being 'funds'. The AIFMD applies to:

- EU managers who manage one or more AIFs (wherever they are based);
- non-EU managers who manage one or more EU AIFs; and
- non-EU managers seeking to market AIFs (wherever they are based) to investors in the EU, subject to some limited exemptions.

The AIFMD does not directly apply to the AIFs themselves, although AIFs remain subject to applicable member state law and regulation, if any.

EU managers are subject to an authorisation requirement under the AIFMD. As a consequence of being authorised, a manager may market units or shares in the AIF it manages across EU member states under a passport regime. Authorised managers are subject to a range of obligations including in relation to governance and conduct-of-business standards, capital requirements, enhanced disclosure and transparency requirements and remuneration policies. In addition, authorised managers must appoint a depositary on behalf of each AIF that they manage. Authorised managers are also subject to limitations on leverage and face restrictions in relation to 'asset stripping' (meaning restrictions on distributions and capital reductions in certain portfolio companies) for two years following acquisition. As discussed below, EU managers will be subject to new rules on marketing and reverse solicitation from August 2021.

Member states may allow non-EU managers to market units or shares in the non-EU AIFs that they manage to professional investors under national private placing regimes. There is a degree of harmonisation in relation to these regimes, as managers using this route for marketing must comply with elements of the AIFMD disclosure regime, and there must be suitable cooperation arrangements between the relevant member state and the regulator of the home states of the manager and the AIF. In addition, the jurisdictions of establishment of the non-EU manager and any non-EU AIFs that it manages must not be listed as a non-cooperative country and territory by the Financial Action Task Force. EU member states, however, are free to 'gold plate' their national private placement regimes to add in other requirements before marketing can begin.

Most national regimes continue to permit 'reverse solicitation' and passive marketing without the need for compliance with the AIFMD or private placement regimes. The availability and boundaries of this concept vary widely across member states.

Future developments, including Brexit

Given the importance of London as the EU's largest centre for financial services, it is expected that Brexit will have a disproportionate impact in relation to the financial sector. On 31 January 2020, the UK ceased to be a member of the EU pursuant to the terms of the EU-UK Withdrawal Agreement. However, the EU-UK Withdrawal Agreement provides for a transition period during which EU law, including financial services related rules and regulations, will continue to apply to and in the UK until 31 December 2020. It is anticipated that the future relationship between the UK and the EU will be governed by a trade agreement that is to be negotiated during the transition period. The shape of a final deal between the EU and UK on a future trading relationship, is still, at the time of writing, far from being settled. In broad terms, the key financial regulatory issues arising from Brexit are the following.

Passporting

As the UK will no longer be a member of the EU single market, UK financial institutions, including subsidiaries of US and other non-EU parent companies, will no longer be able to benefit from passporting rights at the end of the transition period.

Assuming the UK becomes a third country for the purposes of EU legislation, the fundamental basis of market access in the future will be equivalence under some existing EU financial services laws. UK financial services firms would be treated in the same way as firms from other non-EU third countries. Rights under third-country equivalence regimes are not a full substitute for passporting rights and do not cover all areas of business carried on by international banking groups. Moreover, an equivalence decision may take time to implement, so it is possible that this route may not be available to firms immediately at the end of the transition period.

To combat the sudden loss of passporting rights for UK firms providing services in the EU as well as for EU firms servicing clients in the UK, which has the potential to cause significant market disruption, the UK has introduced the temporary permissions regime (TPR), which will allow firms based in the EU that currently access UK clients and markets via passporting rights to continue operating in the UK after the transition period ends, while seeking full UK authorisation. During the transition period firms relying on the TPR can apply to become fully authorised (or recognised in the case of funds) in the UK or wind down their activities in an orderly manner. The TPR is available to banks, insurers, investment firms, electronic money and payment institutions, Undertakings for the Collective Investment in Transferable Securities (UCITS) schemes and AIFs.

Derivatives clearing

In order to avoid significant disruption for financial and non-financial counterparties across the EU, which could occur if UK financial institutions are restricted from providing derivatives-dealing services to EU counterparties and if London-based CCPs (which currently fulfil a critical role in the clearing of derivatives in the EU as a whole) are also prevented from providing clearing services to EU counterparties post-Brexit, the Commission adopted and extended two temporary equivalence decisions that would have applied if there had been a no-deal Brexit.

At the time of writing, it remains to be seen whether derivatives clearing will be addressed in any UK-EU trade agreement.

Legal and regulatory divergence

Most of the UK's financial services regulation is based on EU law. That said, substantial further EU legislative work is expected to modify a number of these laws, so it is possible that the regimes could diverge rapidly after Brexit. In general with financial services legislation, an assessment will need to be made in the UK whether to align with EU legislation or diverge; the greater the divergence, the more the dual burdens on cross-border firms.

The UK will likely not be part of the ESA framework after Brexit and will have no influence in the development of primary or secondary EU legislation or guidance. The UK has been a significant force in the area of financial services legislation, so its withdrawal may impact the legislative agenda and ultimately the quality of the legislation produced.

Even before the Brexit referendum, a number of new regulatory initiatives were in progress or under consideration, in part to recognise the need to reflect newly agreed international standards (such as the Financial Stability Board's total loss-absorbing capacity standard (TLAC) for global systemically important banks) as well as building on the EU's own policy priorities around building a banking union within the eurozone and the creation of a capital markets union. Important recent EU regulatory initiatives in financial services include:

- The banking reform legislative package which was published on 23 November 2016 and adopted by the European Parliament and the Council of the European Union during 2019, consisting of:
    - a set of amendments to the CRD IV package, including amendments to the leverage ratio, the net stable funding ratio and capital standards, and new proposals for a requirement to establish intermediate EU holding companies where two or more banking institutions established in the EU have the same ultimate parent in a non-EU country;

- a proposal to amend the Single Resolution Mechanism Regulation as regards loss-absorbing and recapitalisation capacity for credit institutions and larger investment firms; and
- proposals to amend the existing Bank Recovery and Resolution Directive in relation to TLAC requirements and regarding the ranking of unsecured debt instruments in the insolvency hierarchy.
- While the banking reform package entered into force on 27 June 2019, with respect to the revised Capital Requirements Regulation (CRR II), the majority of the amendments will apply from 28 June 2021 and with respect to the revised Capital Requirements Directive (CRD V), EU member states will be required to adopt national legislation to comply by December 2020. Other requirements (eg, the requirements for non-EU groups to establish an intermediate EU holding company) will be subject to transitional periods running far beyond December 2020.

- Amendments to EMIR, as discussed above.
- The European Parliament adopted the Cross-border Distribution Directive and Cross-border Distribution Regulation during 2019, amending the AIFMD by introducing new pre-marketing rules for EU fund managers. The objective of the amendments is to harmonise the ability of EU managers to conduct preliminary fund marketing activities in the EU by setting out rules on pre-marketing and reverse solicitation. In particular, EU managers will be required to notify their home state regulators that they are pre-marketing, which in turn will have implications for reliance on reverse solicitation. The amendments will not affect non-EU managers marketing funds in the EU under national private placing regimes. The new pre-marketing rules are expected to apply from August 2021.
- The ESAs and the European Central Bank have, on a number of occasions, issued opinions and expressed views in speeches regarding the impact of Brexit on the licensing of financial services firms in the EU. For example, on 31 May 2017, ESMA published an opinion on general principles to support supervisory convergence in the context of authorised firms relocating from the UK. The opinion addresses regulatory and supervisory arbitrage risks that may arise from such relocations and sets out general principles for a common supervisory approach across the member states. The opinion is underpinned in the EU by a concern that a regulatory 'race to the bottom' may occur among European regulators to win business post-Brexit. To guard against such arbitrage, the opinion encourages progress in supervisory convergence to improve integration and ensure financial stability across the EU and make clear that 'substance' requirements will have to be met, with the full force of EU regulation applying to firms that choose to move from the UK. ESMA has promised to maintain its focus on supervisory convergence and assessing risks in financial markets during 2020.

The Commission and the ESAs continue to adopt a position that advocates 'more EU' as the solution to financial regulatory issues that arose during the crisis and beyond. The direction of travel is therefore towards more powers for the ESAs and the European Central Bank, with even less discretion available to national regulators. The impact of Brexit will likely have a material impact on the operation and regulation of the EU's financial markets, given the critical importance that London currently holds.

Davis Polk

Mark Chalmers
mark.chalmers@davispolk.com

Jennifer Duffy
jennifer.duffy@davispolk.com

Simon Witty
simon.witty@davispolk.com

5 Aldermanbury Square
London
EC2V 7HR
United Kingdom
Tel: +44 20 7418 1300
Fax: +44 20 7418 1400
www.davispolk.com/offices/london

Hong Kong

Karen Chan and Joyce Chow
Davis Polk & Wardwell LLP

REGULATORY FRAMEWORK

Regulatory authorities

1 What national authorities regulate the provision of financial products and services?

The Hong Kong system of financial regulation reflects a modified institutional approach, with different regulators largely responsible for the oversight of different types of financial institutions.

The two principal authorities responsible for the regulation of banking, securities and derivatives products and services are the:

- Hong Kong Monetary Authority (HKMA), which regulates banks; and
- Securities and Futures Commission (SFC), which regulates securities, futures and other contract markets, as well as certain entities that participate in those markets.

There is increasing overlap among and between regulators, particularly as banks expand the range of securities activities in which they are engaged. See question 2, regarding the activities regulated by each authority.

2 What activities does each national financial services authority regulate?

The HKMA oversees all aspects of authorised banking institutions within its jurisdiction, including banks, restricted licence banks (eg, merchant banks) and other deposit-taking companies. It supervises these authorised institutions on a consolidated basis, with the aim of promoting the safety and stability of the banking system, including in respect of local and overseas branches and subsidiaries. The principal areas of HKMA supervision include capital adequacy and liquidity, exposure concentration, resolution, and anti-money laundering and counter-terrorism financing (AML/CTF) obligations (eg, customer due diligence), with different requirements applicable to locally and foreign incorporated institutions.

The SFC is responsible for the licensing (or registration) and supervision of intermediaries and individuals, including broker-dealers, advisers and funds, engaged in a wide range of securities and futures activities, including:

- dealing in securities;
- dealing in futures contracts;
- leveraged foreign exchange trading;
- advising on securities;
- advising on futures contracts;
- advising on corporate finance;
- providing automated trading services;
- securities margin financing;
- asset management; and
- providing credit rating services.

In January 2020, the SFC issued guidance to private equity firms and family offices clarifying the circumstances in which they will need to seek a licence for their activities.

The SFC is also responsible for overseeing market operators, including, among others:

- Hong Kong Exchanges and Clearing Limited (HKEX), which operates:
  - the Stock Exchange of Hong Kong (SEHK);
  - the Hong Kong Futures Exchange;
  - clearing houses; and
  - alternative trading platforms (eg, dark pools);
- overseeing takeovers and mergers of listed companies; and
- the regulation of investment products (including, from April 2019, investment products offered by intermediaries via online platforms).

For example, the SFC and the SEHK work closely together in relation to tackling backdoor listings and shell activities. Backdoor listings involve transactions or arrangements (usually involving listed shell companies) that are structured to achieve a listing of assets while circumventing the requirements that apply to a new listing applicant. Problems with such listings have received widespread attention in Hong Kong. In July 2019, the SFC issued a statement declaring that, in addition to the SEHK's regulation of listed companies, the SFC itself would not hesitate to use its statutory powers, including its investigation powers, to take action against parties involved in backdoor listings. The statement enumerated the factors the SFC would consider in exercising its statutory powers in that context.

Authorised banking institutions supervised by the HKMA must register with the SFC as to regulated securities activities undertaken in Hong Kong, but the HKMA is responsible for the day-to-day oversight of any such activities performed by these authorised institutions. The precise role and responsibilities of the HKMA in respect of the securities activities of authorised institutions are set out in a series of memoranda of understanding between the HKMA and the SFC. The Secretary for Financial Services also plays a coordinating role, and helps to set policy for the securities and futures markets generally.

3 What products does each national financial services authority regulate?

As described above, the HKMA exercises comprehensive supervisory oversight over all of the activities of authorised banking institutions, rather than regulating particular types of products.

The SFC regulates licensed (or registered) institutions on the basis of the activities in which they are engaged, for example, by imposing principles-based business conduct standards. These conduct standards are applicable to all licensed and registered institutions (and individual persons), and include expectations and requirements as to the suitability of products offered or sold to third-party customers.

Through its supervisory and rule-making authority over market operators, the SFC also regulates certain financial products, including securities and futures. Thus it has indirect authority over the manner in which these products are transacted, for instance, on exchanges or over-the-counter. In addition, the SFC directly authorises and regulates investment products, including, among others:

- closed-end funds;
- exchange traded funds;
- leveraged and inverse products;
- pooled retirement funds;
- unit trusts and mutual funds;
- structured investment products;
- real estate investment trusts;
- unlisted shares and debentures; and
- open-ended fund companies.

In March 2019, the SFC reminded parties engaging in security token offerings (STOs) that such activities are likely subject to regulation under the Securities and Futures Ordinance (Cap. 571) (SFO). STOs generally refer to specific offerings which are structured to have features of traditional securities offerings and which involve security tokens which the SFC describes as 'digital representations of ownership of assets (eg, gold or real estate) or economic rights (eg, a share of profits or revenue) utilising blockchain technology'. The SFC reminded intermediaries who market or distribute security tokens that they must comply with all existing legal and regulatory requirements, including observing the requirements on the distribution of virtual assets funds as set out in its circular of November 2018.

With regard to virtual assets (eg, digital currencies, crypto assets), in November 2018, the SFC clarified its regulatory expectations in relation to intermediaries involved in the distribution of virtual asset funds and the management of virtual asset portfolios. In November 2019, it followed that action up with a position paper setting out a new regulatory framework for virtual asset platforms and invited licensing applications from platform operators who are able to comply with new licensing criteria and compliance requirements proposed in the position paper. In addition, in that same month the SFC also issued a warning to investors about the risks associated with the purchase of virtual assets (eg, bitcoin) futures contracts in Hong Kong.

Authorisation regime

4 What is the registration or authorisation regime applicable to financial services firms and authorised individuals associated with those firms? When is registration or authorisation necessary, and how is it effected?

As to securities and futures activity, financial services firms must be licensed by the SFC before engaging in any of the regulated activities set out in question 2, subject to narrow statutory exemptions. Licensing is necessary when financial services firms carry out a regulated activity, as well as when they hold themselves out as doing so. A licence must be obtained (or a relevant exemption identified) for each type of regulated activity the financial services firm intends to undertake.

Licensing is also necessary if a financial services firm actively markets to the public in Hong Kong any service that would be a regulated activity if performed in Hong Kong. This is true whether the firm is marketing its services from Hong Kong or overseas, including when it does so through a third party. For instance, a US-based asset manager soliciting clients for its US-based services in Hong Kong would need to be licensed for asset management activity in Hong Kong, even if the solicitation was undertaken through its Hong Kong-licensed subsidiary.

Individuals must also be licensed before performing a regulated activity on behalf of their licensed corporation. In addition, any executive directors (ie, senior managers) supervising a licensed corporation's regulated activities must also be licensed as 'responsible officers'.

Temporary licences are available to both firms and individuals if they will undertake regulated activity only on a short-term basis, and it is the SFC's expectation that such licences will be obtained before any regulated activity is undertaken, even in the case of day-long business meeting in Hong Kong, for instance.

To receive a licence, a firm or individual must apply to the SFC. Different requirements apply to each type of regulated activity, but at a minimum, the application process ordinarily requires the submission of extensive materials, including detailed business plans, biographies of senior employees, directors and officers, and other corporate and individual records. All licensed persons – firms or individuals – must also, at a minimum, demonstrate that they are 'fit and proper', in connection with which the SFC evaluates the applicant's financial status, qualifications, competence, honesty, fairness, reputation and character. Licensed firms must also comply with additional requirements, including financial resources rules (eg, rules relating to minimum paid-up share capital and liquid capital) and insurance rules. The application process for temporary licences is less complex, especially for individuals.

Banking organisations are subject to similar authorisation requirements, albeit overseen by the HKMA rather than the SFC. Authorisation is required when banking activities are undertaken in Hong Kong, and also when they are marketed to customers in Hong Kong. As noted in question 2, Hong Kong has a three-tier banking system that includes banks, restricted licence banks and deposit-taking companies. Different regulations, including different authorisation requirements, apply to locally incorporated banking organisations than to the Hong Kong branches of overseas banks. Otherwise, the application requirements are similar to those applicable to financial services firms licensed by the SFC, and banking entities seeking to engage in securities and futures activities in Hong Kong must also be licensed by the SFC.

The HKMA has issued the first batch of licences to three virtual banks (ie, banks that deliver retail banking services primarily, if not entirely, through the internet or other electronic channels rather than physical branches) in March 2019. As of 31 December 2019, there are in total eight virtual banks licensed by the HKMA. Virtual banks will be subject to the same set of supervisory principles and key requirements as conventional banks, although some of the requirements may be adapted to suit this new business model.

Legislation

5 What statute or other legal basis is the source of each regulatory authority's jurisdiction?

The importance of financial services to Hong Kong as an international financial centre is recognised in its Basic Law, which also gives the government the authority to 'formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with the law'.

Otherwise, the jurisdiction of both the HKMA and the SFC is proscribed by statute: the Banking Ordinance (Cap. 155) in the case of the HKMA, and the SFO in the case of the SFC.

These ordinances set out the supervisory, examination and enforcement powers of the HKMA and SFC, respectively, in addition to conferring upon each regulator the authority to promulgate more particularised subsidiary legislation (ie, rulemaking with the force of law) and non-binding guidance in respect of defined topics (eg, product suitability).

In relation to AML/CTF, the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615) (AMLO) sets out the statutory requirements relating to customer due diligence (CDD) and record-keeping for specified financial institutions, and the powers of

the relevant authorities (including the HKMA and SFC) to supervise financial institutions' compliance with the requirements.

6 What principal laws and financial service authority rules apply to the activities of financial services firms and their associated persons?

HKMA

The principal statute applicable to institutions authorised by the HKMA is the Banking Ordinance (Cap. 155).

The Banking Ordinance sets out the requirements for authorisation of financial services firms seeking to provide banking services, the HKMA's powers of direction and examination, restrictions on the ownership and management of authorised institutions, and liquidity and capital requirements, among others. It also authorises the promulgation by the HKMA of subsidiary legislation addressing a range of topics, from capital and liquidity requirements to disclosure rules, in more particularity.

In addition to the Banking Ordinance and associated subsidiary legislation, institutions authorised by the HKMA must also comply with the minimum expectations and standards set out in the HKMA's Supervisory Policy Manual. The Supervisory Policy Manual codifies the HKMA's supervisory policies and practices, some of which reflect requirements under the Banking Ordinance or AMLO, while others reflect industry best practices. Among the regulatory topics it addresses are corporate governance; internal controls; capital adequacy; credit, interest rate, operational and liquidity risk management; securities activities; and money laundering.

SFC

The principal statute applicable to entities and persons licensed or regulated by the SFC is the SFO. The SFO sets out the licensing requirements for entities conducting regulated activity in Hong Kong; record-keeping, reporting and disclosure requirements; and civil, criminal and disciplinary enforcement regimes in respect of market misconduct. The SFO also confers upon the SFC the authority to promulgate subsidiary legislation addressing a wide range of topics including the treatment of client monies and securities, professional investors, short positions, contract limits, price stabilisation, and investor compensation.

In the case of both the HKMA and SFC, the regulatory requirements reflected in statutes, subsidiary legislation and other binding policy statements are supplemented by a variety of codes of conduct, guidelines and circulars with varying degrees of legal effectiveness.

Scope of regulation

7 What are the main areas of regulation for each type of regulated financial services provider and product?

Institutions authorised by the HKMA are supervised on a consolidated basis. The main areas of regulation and supervision are registration; safety and soundness; capital and liquidity; internal controls and governance; business conduct; risk management (including AML/CTF), record-keeping, reporting and disclosure. Pursuant to a memorandum of understanding (MoU) between the HKMA and SFC, the HKMA is also responsible for supervising the securities activities of HKMA-authorised institutions on a day-to-day basis, with the SFC principally responsible for enforcement action in respect of misconduct arising from such activities.

The SFC, unlike the HKMA, only regulates certain defined securities and futures activities. In respect of these activities, it regulates, among other things:

- licensing requirements;
- business conduct (ie, the standard of care afforded customers);
- market conduct;
- internal controls, governance and supervision (including AML/CTF);
- the treatment of client securities and monies;
- record-keeping, reporting and disclosure obligations;
- the timing and format of contract notes; and
- various activity restrictions.

Additional requirements

8 What additional requirements apply to financial services firms and authorised persons, such as those imposed by self-regulatory bodies, designated professional bodies or other financial services organisations?

The SFC is responsible for licensing market operators, most notably the SEHK, the Hong Kong Futures Exchange and their associated clearing entities. These market operators act as self-regulatory bodies, but also as frontline regulators. Any person seeking to trade or clear through their facilities must comply with the policies, rules and procedures promulgated by each operator (and approved by the SFC). In the case of the SEHK, for instance, these rules govern , among other topics:

- admissible order types and sizes;
- trading hours;
- closing mechanisms;
- trade reporting;
- trading misconduct;
- maximum allowable position and lot sizes;
- the trading engine; and
- short-selling restrictions.

Importantly, the SEHK is also the frontline regulator in respect of listing and listing applications.

In many cases, the rules promulgated by the market operators mirror those promulgated and enforced by the SFC. In practice, the SFC thus acts as the principal enforcement authority for the market operators.

ENFORCEMENT

Investigatory powers

9 What powers do national financial services authorities have to examine and investigate compliance? What enforcement powers do they have for compliance breaches? How is compliance examined and enforced in practice?

Both the HKMA and the SFC have the power to conduct on-site inspections and examinations of the financial services firms they regulate, and to compel the production of certain documents. Both regulators also conduct off-site surveillance – the HKMA of the financial condition of the institutions it authorises, and the SFC of market conditions and trading activity.

In connection with these powers of inspection and surveillance, both regulators are also given the authority to conduct investigations, which can lead to disciplinary, civil or criminal enforcement actions, as detailed in question 10.

Disciplinary powers

10 What are the powers of national financial services authorities to discipline or punish infractions? Which other bodies are responsible for criminal enforcement relating to compliance violations?

Both the HKMA and the SFC are authorised to take disciplinary or civil enforcement action (subject to the approval of the Department

of Justice) in connection with regulatory breaches. A wide range of sanctions is available even in the disciplinary context, including licence revocation or suspension, fines and public reprimands, among others. In many cases, the HKMA and the SFC also require the entities or persons responsible for regulatory violations to strengthen and enhance internal controls and governance. In the civil context, the SFC can also petition the court for winding-up or bankruptcy orders, restoration orders, declarations that securities transactions are void, or for receivership. In addition, the courts and relevant tribunals can require disgorgement, impose financial penalties and enforce activity restrictions and prohibitions on future conduct.

The HKMA and SFC can also seek criminal prosecution in connection with certain regulatory breaches. The SFC can prosecute 'summary offences' on its own, but must refer any indictable offences to the Department of Justice. The HKMA must refer all potential offences to the Department of Justice for prosecution..

The Independent Commission Against Corruption (ICAC) is an independent anti-corruption agency in Hong Kong, which is responsible for investigating corrupt practices and offences under Hong Kong's anti-corruption and anti-bribery laws. In August 2019, the SFC and the ICAC entered into an MoU to formalise and enhance collaboration between the two bodies in combating corrupt and illicit activities relating to Hong Kong's securities and futures industry. The MoU sets out a framework for various matters including referral of cases, joint investigations, exchange and use of information.

Tribunals

11 What tribunals adjudicate financial services criminal and civil infractions?

Hong Kong has a number of specialised tribunals responsible for the adjudication of disciplinary and civil financial services infractions. In most cases, the regulatory authorities are also able to pursue civil enforcement actions in the Hong Kong courts.

SFC disciplinary decisions, for instance, are subject to appeal to the Securities and Futures Appeals Tribunal, where a full de novo review of the disciplinary proceedings is conducted by a three-member panel consisting of a chairman and two lay members. Final orders entered by the Securities and Futures Appeals Tribunal can be registered in or appealed to the Hong Kong courts.

Similarly, civil breaches of market misconduct provisions are heard by the Market Misconduct Tribunal, a three-member panel (one judge and two lay members) in which the SFC acts as the presenting officer. The Tribunal can issue injunctions, order disgorgement, or impose a prohibition on dealing in securities, taking management roles in listed companies or engaging in future misconduct. Subsequent violations of its orders are punishable by imprisonment and fines.

Otherwise, civil actions are dealt with by the Hong Kong courts.

Penalties

12 What are typical sanctions imposed against firms and individuals for violations? Are settlements common?

In the disciplinary setting, the most common sanctions are fines (ordinarily three times the profit earned or loss avoided), public reprimands and partial licence suspensions. Penalties can range from incidental amounts to more than US$50 million, depending on the severity and scope of the relevant violations. Settlement of disciplinary actions is relatively common, but the regulators nearly always require some form of public reprimand.

For civil enforcement actions, the full range of economic and equitable sanctions are available, with disgorgement and prohibitions on future activity (eg, acting as the director of a listed company) being particularly common. Settlements of civil actions are also quite common, although statistics as to the rate of settlement are not publicly available.

COMPLIANCE PROGRAMMES

Programme requirements

13 What requirements exist concerning the nature and content of compliance and supervisory programmes for each type of regulated entity?

For financial services firms engaged in securities and futures activity, the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) enshrines compliance as one of its nine general principles, and sets out numerous principle-based requirements in respect of internal controls, IT infrastructure and trading systems, the disclosure of firm financials, the handling of client assets, and compliance obligations. Other relevant subsidiary rules and regulations include the Securities and Futures (Accounts and Audit) Rules, the Guidelines on Anti-Money Laundering and Counter-Terrorist Financing, and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC.

The HKMA's Supervisory Policy Manual also sets out detailed guidance as to the compliance programmes expected of authorised banking institutions, the principal focus of which is risk management. The Supervisory Policy Manual also includes a Code of Conduct, which sets out the standards of business conduct and competence expected of authorised institutions and their employees.

Gatekeepers

14 How important are gatekeepers in the regulatory structure?

Gatekeepers perform crucial functions within Hong Kong financial services firms. For firms engaged in regulated securities and futures activities, the role of gatekeepers is governed by the SFO, its subsidiary rules and regulations, and codes and guidelines issued by the SFC. Under the SFO, firms engaged in regulated securities and futures activities in Hong Kong must have at least one 'responsible officer' for each regulated activity they are licensed to conduct. As recent cases have shown, responsible officers of licensed corporations are expected to actively supervise the functions they oversee and to bear primary responsibility for compliance, including potentially being subject to disciplinary penalties for compliance failures. This expectation is also codified in the Code of Conduct applicable to all licensed entities.

Licensed corporations are also subject to the 'managers-in-charge' regime, which aims to more clearly define who should be regarded as senior management of licensed corporations, and enhance individual accountability. The SFC has identified eight core functions of licensed corporations and requires licensed corporations to designate a manager-in-charge for each. Among the core functions are compliance; AML/CTF; finance and accounting; risk management; and operational control and review. The managers-in-charge overseeing these gatekeeping functions are subject to SFC's disciplinary powers, even if they are not themselves licensed persons. This means that traditional compliance, back-office and middle-office functions are brought within the scope of the SFC's authority.

These requirements also apply to banking organisations authorised by the HKMA, but registered with the SFC to conduct securities and futures activities. Otherwise, the HKMA takes a more traditional approach to the role of gatekeepers and corporate governance, largely relying on directors and senior officers to manage risk and ensure compliance. The HKMA's Supervisory Policy Manual does, however,

set out detailed and extensive guidance as to the role of the internal audit function, including the expectation that authorised institutions will, in most cases, have an audit committee and that the internal audit function will reflect the size, scope and complexity of an authorised institution's business and operations. With respect to risk management and compliance, it is expected that there will be separate, designated risk and compliance officers, with the board of directors principally responsible for ensuring that these functions are adequately resourced.

Directors' duties and liability

15 What are the duties of directors, and what standard of care applies to the boards of directors of financial services firms?

Common law directors' duties apply to the boards of directors of financial services firms in Hong Kong. These include the duties to:

- act in good faith for the benefit of the company as a whole;
- exercise power solely for proper purposes;
- exercise independent judgement and refrain from delegation without proper authorisation;
- exercise care, skill and diligence;
- avoid conflicts of interest or abuses of position;
- avoid unauthorised use of firm property or information; and
- maintain proper accounting records.

The statutory standard of care applicable to directors is set out in the Companies Ordinance (Cap. 622). This statute expressly displaces the common law standard of care. In determining whether a director has breached his or her duties, courts in Hong Kong will apply a mixed subjective and objective test, comparing the conduct of the director to that of a 'reasonably diligent person' having the general knowledge, skill and experience reasonably expected of a person in the director's position (the objective component) and the knowledge, skill and experience that the specific director actually possesses (the subjective component).

Generally, directors of financial services firms should also bear in mind the need for management to instil a strong compliance 'tone from the top'. This is especially important in light of heightened regulatory focus on individual and senior management accountability. In May 2017, the SFC published a reminder of steps that directors may take to minimise the risk of corporate misconduct and promote a culture of good corporate governance. These include the following:

- Leading by example, directors are expected to regularly discuss governance-related matters, including by actively consulting senior management regarding observed issues within the firm, and to ensure effective channels for the escalation of concerns and suggestions of improvements.
- In order to promote timely identification of issues, directors should demonstrate genuine interest in the firm's affairs, evidenced by attendance at board meetings and obtaining updates on management accounts and corporate performance.
- In matters where personal conflicts of interest arise, directors should abstain from involvement.
- On a firm-wide level, directors should ensure the implementation of effective internal controls and whistle-blowing procedures. Systems of checks and balances should be in place to prevent policies from being overridden without due cause or accountability.

In July 2019, the SFC issued a reminder to directors and advisers of Hong Kong-listed issuers about their statutory and other legal duties they owe when evaluating or approving the acquisition or disposal of a company or business. This announcement followed the SFC's issuance of 'letters of concern' to more than 46 listed issuers in 2017 and 2018 in relation to proposed corporate transactions. The July 2019 statement outlined recurring types of misconduct in relation to corporate acquisitions and disposals which have given rise to SFC concern and, in some cases, intervention by the SFC. These included the following:

- lack of independent judgement and accountability;
- proper investigation and due diligence; and
- suspicious connected parties (eg, undisclosed relationship or arrangement among purported independent third parties).

16 When are directors typically held individually accountable for the activities of financial services firms?

Directors may be held individually accountable for the activities of financial services firms as a result of regulatory breaches. For instance, the SFO empowers the SFC to seek injunctive relief and other orders on behalf of investors against persons who contravene (or aid, abet, induce, or are involved in the contravention of) any provision of the SFO. The SFO also authorises civil actions against directors who fail to take reasonable measures to establish safeguards against market misconduct. Directors of licensed corporations who are also responsible officers or managers-in-charge are also subject to the SFC's disciplinary powers if found liable for the misconduct of financial services firms.

Recent enforcement cases reflect Hong Kong's regulatory focus on director and senior management accountability for the activities of financial services firms, with the SFC bringing civil proceedings against individual directors for, among other things, failing to act in a company's best interest in connection with the late disclosure of inside information. These cases serve as reminders of directors' personal accountability to their corporations, and of directors' responsibilities to stay informed and alert to governance or compliance issues within their firms.

Private rights of action

17 Do private rights of action apply to violations of national financial services authority rules and regulations?

Private rights of actions for regulatory violations are available in only very limited circumstances. Such actions would be relevant for individuals who suffer pecuniary loss as a result of another person committing the market misconduct offences set out in the SFO. These offences include:

- insider dealing;
- false trading;
- price rigging;
- disclosure of information about prohibited transactions;
- disclosure of false or misleading information, inducing transactions; and
- stock market manipulation.

They also include the offences of:

- use of fraudulent or deceptive devices in securities, futures contracts or leveraged foreign exchange trading;
- disclosure of false or misleading information inducing transactions in leveraged foreign exchange trading; and
- falsely representing dealings in futures contracts on behalf of others.

Persons found liable in connection with private rights of action brought pursuant to these provisions are required to pay damages if it is 'fair, just and reasonable' in the circumstances. Courts may also impose injunctive relief in addition to or in lieu of orders for damages. Potential defendants under these provisions are not limited to persons directly perpetrating a market misconduct offence. Investors also may seek to recover from persons who knowingly assist or connive with others in the perpetration of market misconduct. Officers of corporations also may be named as defendants if market misconduct was perpetrated by the corporation with the officer's consent or connivance. 'Officers' is widely defined

in the SFO: directors, managers or secretaries, or any other person involved in the management of a corporation, are all deemed 'officers of a corporation'.

Standard of care for customers

18 What is the standard of care that applies to each type of financial services firm and authorised person when dealing with retail customers?

In Hong Kong, the relationship between retail customers and financial institutions is principally a matter of contract, as applied within the context of the common law duties of banks.

In addition, financial services firms licensed or regulated by the SFC must, as a condition of their licences meet minimum, principles-based regulatory standards governing the treatment of customers which are principally set out in the SFC's Code of Conduct. The Code of Conduct requires licensed entities to:

- act honestly, fairly and diligently, and in the best interests of their clients;
- to obtain adequate information about the financial situation, investment experience and objectives of clients;
- to make adequate disclosures of relevant information to clients; and
- to properly account for and safeguard client assets.

The Code of Conduct also elaborates more particularised minimum requirements in respect of, among other things, the content of client agreements and the principles of prompt and best execution.

Banks authorised by the HKMA are expected to comply with the recommended practices prescribed in the Code of Banking Practice, which was promulgated by industry associations, but endorsed by the HKMA. The Code of Banking Practice, although not binding or a condition of authorisation, sets out similar, albeit more particularised expectations for the treatment of banking customers. These are set out by reference to specific banking activities, including account management, card services, payment services, and electronic banking services, among others. These expectations reflect a set of general principles announced in the Code, among which are the equitable and fair treatment of customers, with special attention given to the needs of vulnerable groups.

19 Does the standard of care differ based on the sophistication of the customer or counterparty?

In respect of securities and futures activity, including when such activity is performed by banks, the standard of care owed to customers varies based on the sophistication of the customer (ie, their net worth and investment experience).

Under the SFO and related guidance promulgated by the SFC, certain customers may be classified as 'professional investors'. In such cases, certain regulatory requirements are relaxed, including those pertaining to:

- obtaining information about a customer's financial condition, experience and objectives;
- the minimum contents of client agreements;
- the suitability of investment products; and
- the type of transaction-related information that must be disclosed to clients.

The HKMA also recognises certain categories of customers (eg, private banking customers) for which suitability and other requirements are reduced. In respect of banking activity, however, the standard of care does not vary based on customer sophistication, aside from the expectation elaborated in the Code of Banking Practice that banks should devote special attention to vulnerable populations (eg, the elderly).

Rule making

20 How are rules that affect the financial services industry adopted? Is there a consultation process?

With certain exceptions, all subsidiary legislation in Hong Kong ordinarily must go through a process of consultation prior to adoption. This is true for subsidiary legislation adopted by both the SFC and the HKMA (and in some cases, the regulatory bodies are also required to consult with each other). Subsidiary legislation refers to those rules and guidelines promulgated pursuant to express authority in the relevant governing statutes (ie, the SFO and Banking Ordinance).

The consultation process for subsidiary legislation involves the circulation of proposed rules for public consideration, the opportunity for public comment, the circulation of consultation conclusions setting out any public comments received, regulator responses to these comments (as well as any new amendments that substantively differ from the original draft), and publication of the final rules for adoption.

Both the HKMA and SFC also regularly publish circulars and other guidance in which they set out their interpretations of requirements set out in statute or subsidiary legislation. No consultation ordinarily is undertaken in connection with such interpretive guidance as it does not have the force of law.

CROSS-BORDER ISSUES

Cross-border regulation

21 How do national financial services authorities approach cross-border issues?

Hong Kong largely takes a territorial approach to the regulation of its securities and futures markets. As explained in question 4, financial services firms must be licensed by the SFC to conduct regulated securities and futures activities whenever they conduct those activities in Hong Kong, as well as when they actively market to the public in Hong Kong any service that, if performed in Hong Kong, would be a regulated activity. This is true whether the firm is marketing its services from Hong Kong or abroad, including when it does so through a third party (eg, a subsidiary or affiliate). Even when such regulated activity, or the marketing of regulated activity, is conducted in Hong Kong on a temporary or short-term basis only (eg, a one-off meeting with a brokerage client), a temporary licence is required.

Banking organisations authorised in Hong Kong are also subject to regulation in respect of their overseas activity, including the HKMA's powers of inspection. They cannot open overseas branches (or acquire overseas banks) without the approval of the HKMA, and must regularly disclose to the HKMA the assets and liabilities of their overseas entities. The HKMA frequently communicates with overseas counterparts and can disclose information about the operations of institutions authorised in Hong Kong to overseas regulators, as long as there are adequate privacy measures in place. The HKMA also looks to the home regulators of banking organisations incorporated overseas in determining whether to authorise them to conduct banking activity in Hong Kong. Such organisations can only be authorised in Hong Kong if the HKMA is satisfied that they are adequately supervised by their home banking regulator. Without authorisation, overseas banks cannot engage in any banking business, although they can open local representative offices to liaise with local customers.

The SFC and HKMA also both cooperate extensively with international regulators, especially Mainland regulators.

- For example, the SFC and the China Securities Regulatory Commission (CSRC) hold regular meetings to discuss a range of matters concerning cross-boundary enforcement co-operation. In July 2019, The Ministry of Finance of the People's Republic of China

(MOF), the CSRC and the SFC entered into a MoU concerning the obtaining of audit working papers in the Mainland arising from the audits of Hong Kong-listed Mainland companies. The agreement will facilitate the SFC's access to audit working papers – created by Hong Kong accounting firms in their audits and kept in the Mainland – when conducting investigations into mainland-based issuers or listed companies, and their related entities or persons. Under the MoU, the MOF and the CSRC will provide the fullest assistance in response to SFC's requests for investigative assistance regarding the provision of audit working papers.

- The HKMA has signed MoUs with the China Banking and Insurance Regulatory Commission to enhance the exchange of supervisory information and co-operation, in addition to various other collaborative initiatives with the People's Bank of China, including those relating to mutual bond market access between Hong Kong and Mainland China (Bond Connect).

The SFC has MoUs with Switzerland, the United States and Japan to facilitate varying degrees of mutual assistance on a cross-border basis and frequently makes or receives requests for assistance from regulators globally. The HKMA has similar cooperative arrangements with foreign jurisdictions, including with Australia, Canada, the mainland China, France, Germany, India, Japan, the United Kingdom and the United States.

One potential exception to this territorial approach is the catchall fraud provision of the SFO, which is modelled on Rule 10b-5 in the US, and which the SFC recently used to target insider dealing in Taiwan in securities listed on the Taiwan Stock Exchange. Importantly, significant elements of the fraudulent scheme were devised in Hong Kong, but this enforcement action nevertheless shows that the SFC will use its ostensibly territorial jurisdiction to reach conduct that principally occurs offshore, especially where it has effects on Hong Kong's markets and market participants.

Hong Kong also takes a largely territorial approach to banking regulations, although the HKMA frequently communicates with overseas counterparts and can disclose information about the operations of institutions authorised in Hong Kong to overseas regulators, as long as there are adequate privacy measures in place. The HKMA also looks to the home regulators of banking organisations incorporated overseas in determining whether to authorise them to conduct banking activity in Hong Kong. Such organisations can only be authorised in Hong Kong if the HKMA is satisfied that they are adequately supervised by their home banking regulator. Without authorisation, overseas banks cannot engage in any banking business, although they can open local representative offices to liaise with local customers.

International standards

22 What role does international standard setting play in the rules and standards implemented in your jurisdiction?

Both regulators are active participants in the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system with a view to reducing vulnerability and safeguarding the smooth functioning of financial markets through enhanced information exchange and co-operation in financial supervision and surveillance. Hong Kong's inclusion in the FSB is a recognition of its status as a systemically important financial centre.

In July 2019, the HKMA implemented the Banking (Exposure Limits) Rules which aim to implement the Basel Committee's large exposures standards (introduced in 2014) and also update other exposure limits to keep pace with market developments and contemporary risk management techniques.

In the AML/CTF sector, the SFC and HKMA both work to ensure that the international standards and guidance promulgated by the Financial Action Task Force (FATF) are adequately reflected in Hong Kong's regulatory and compliance framework. In September 2019, FATF announced the results of its recent Mutual Evaluation Report of Hong Kong (FATF Report). The FATF report assessed Hong Kong's AML/CTF regime to be compliant and effective overall, and confirmed that Hong Kong has a strong legal foundation and effective system for combating money laundering and terrorist financing.

- In relation to the securities sector, FATF recognised that the SFC has a reasonable risk-based supervisory framework on AML/CFT and commended the sanctions used by the SFC to enforce AML/CFT requirements. The FATF Report noted that large financial institutions and those belonging to international financial groups generally have a good understanding of money laundering and terrorism financing risks and adequately apply CDD, whereas there is room for improvement among smaller financial institutions.
- In relation to the banking sector, the FATF Report commented on the sector's overall good understanding of money laundering and terrorism financing risks as well as adequate understanding and application of CDD, particularly by large banks and those belonging to international groups. The increased use of data analytics in monitoring by some of the larger banks was also mentioned favourably.

The FATF Report made a number of recommendations for how Hong Kong could improve its AML/CTF framework, including deepening the understanding of the money laundering and terrorism financing risks facing Hong Kong (eg, cross-border financial flows, non-resident customers and politically exposed persons) and improving the monitoring and reporting of suspicious transactions. We expect to see follow-up action on these recommendations by the SFC and HKMA over the course of the next several years.

UPDATE AND TRENDS

Key developments of the past year

23 Are there any other current developments or emerging trends that should be noted?

Both the SFC and HKMA have focused on emerging technologies over the course of 2019, a trend which is likely to continue in 2020. This regulatory focus is evidenced in the SFC's evolving position on the regulation

Davis Polk

Karen Chan
karen.chan@davispolk.com

Joyce Chow
joyce.chow@davispolk.com

The Hong Kong Club Building
3A Chater Road, 18/F
Hong Kong
Tel: +852 2533 1016
Fax: +852 2533 4316
www.davispolk.com

of virtual asset platforms, as well as its statement on STOs and warning on virtual asset futures contracts. In addition, in October 2019, the SFC issued guidance about electronic storage (eg, cloud-based storage) for regulatory records. For its part, the HKMA has licensed eight virtual banks during the course of 2019, and provided guidance to authorised banking institutions in relation to managing money laundering and terrorist financing risks arising out of virtual assets and virtual asset service providers.

In 2019, the SFC continued its focus on listed companies. For example, it highlighted the conduct of directors in relation to corporate acquisitions and disposals, as well as warning about the potential use of its statutory powers in relation to backdoor listings. Last year also saw a continued enforcement attention on IPO sponsors, particularly in relation to due diligence failures arising in the listing application context.

In late 2019, the SFC issued guidance on market misconduct, targeted at listed companies and asset managers. The guidance was motivated by a concern that special purpose vehicles and other means are being used to conceal ownership and as part of wider arrangements to engage in illicit activities or market misconduct. In relation to listed companies, the SFC reminded them to ensure that their announcements, statements and other documents do not include false, incomplete or misleading information about their counterparties in pending corporate transactions (eg, in relation to the beneficial ownership of counterparties). For asset managers, the SFC provided guidance to assist in their consideration of whether a proposed private fund and discretionary account arrangement or transaction is dubious, and what actions to take in the event that the arrangement or transaction in question is found to be dubious.

United Kingdom

Mark Chalmers, Jennifer Duffy and Simon Witty
Davis Polk and Wardwell London LLP

REGULATORY FRAMEWORK

Regulatory authorities

1 What national authorities regulate the provision of financial products and services?

The main piece of legislation specifying regulated financial services in the UK is the Financial Services and Markets Act 2000 (as amended) (FSMA) and its subordinate legislation. There is a tripartite system of regulators for financial services firms authorised under the FSMA; the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) and the Bank of England Financial Policy Committee (FPC). The scope of each regulator's authority is set out in the FSMA.

The FPC is the dedicated macro-prudential authority, and monitors the stability and resilience of the financial system as a whole, identifying and taking action to reduce systemic risk. The FPC can direct the FCA and the PRA to take certain action to combat systemic risk, but does not itself have direct regulatory responsibility for UK-authorised firms.

The PRA is responsible for the authorisation and prudential regulation and supervision of firms that manage significant risk on their balance sheet (including banks, insurers and systemically important investment firms), while the FCA is responsible for the authorisation, prudential regulation and supervision of all other FSMA firms (including consumer credit firms), as well as the conduct of business of all firms.

The FCA is also responsible for the regulation of conduct in retail and wholesale financial markets, supervision of the trading infrastructure that supports those markets, and the authorisation and supervision of e-money issuers and payment services firms that fall outside the FSMA regulatory regime. The FCA also oversees the Payment Systems Regulator, which is an operationally independent subsidiary of the FCA that is the economic regulator for payment systems.

The PRA and FCA are obliged to ensure that their functions are exercised in a coordinated manner; for example, they must obtain advice or information from each other relating to the exercise of their functions under the FSMA on matters of common regulatory interest. A memorandum of understanding supports the relationship between the two regulators.

2 What activities does each national financial services authority regulate?

The FSMA provides that no person can perform a regulated activity without being authorised or exempt. A regulated activity is a specific activity that relates to a specified type of investment. The FSMA (Regulated Activities) Order 2001, a piece of subordinate legislation under the FSMA, specifies the following activities that, when performed in relation to specified products or investments, are regulated activities in the UK:

- deposit taking;
- issuing electronic money by credit institutions, credit unions and municipal banks;
- insurance-related activities (including effecting a contract of insurance and assisting in the administrator or performance of contracts of insurance);
- investment activities, including arranging deals in investments, advising on investments, dealing in investments, safeguarding and administering investments, managing investments, operating a trading facility and establishing or winding up a collective investment scheme;
- mortgage and home-finance-related activities, including mortgage lending and administration and entering into and administering home reversion and home purchase plans and sale and rent back agreements;
- consumer credit regulated activities;
- claims management activities; and
- other miscellaneous activities such as establishing a stakeholder pension scheme, specified financial benchmark administration activities, bidding in emissions auctions and certain activities in relation to the Lloyd's insurance market.

Agreeing to carry on a regulated activity is also generally a regulated activity.

The PRA is responsible for the authorisation of deposit takers, insurers, managing agents in the Lloyd's insurance market, the Lloyd's insurance market itself, and certain high-risk investment firms that have been designated by the PRA. Firms authorised by the PRA are subject to dual-regulation by the PRA and the FCA – the PRA is responsible for their authorisation, prudential regulation and supervision, while the FCA is responsible for regulating their conduct. All other FSMA firms are authorised, regulated and supervised by the FCA in respect of both prudential and conduct matters.

Separate regulatory regimes exist in the UK for the regulation of payment services and the issuance of electronic money by institutions other than credit institutions, credit unions and municipal banks (under the Payment Services Regulations 2017 (PSRs) and the E-Money Regulations 2011 (EMRs)). The FCA is responsible for the authorisation and supervision of e-money issuers and payment services firms.

3 What products does each national financial services authority regulate?

The following are specified products or investments for the purposes of the FSMA regime:

- deposits;
- e-money;
- contracts of insurance;
- shares;
- instruments creating or acknowledging indebtedness;

- alternative finance investment bonds;
- government and public securities;
- instruments giving entitlements to investments;
- certificates representing certain securities;
- units in a collective investment scheme;
- rights under a pension scheme;
- options;
- futures;
- contracts for differences;
- Lloyd's investments;
- funeral plan contracts;
- regulated mortgage contracts;
- regulated home reversion plans;
- regulated home purchase plans;
- regulated sale and rent back agreements;
- rights to or interests in investments;
- greenhouse gas emissions allowances;
- rights under consumer credit and consumer hire agreements; and
- structured deposits.

Authorisation regime

4 What is the registration or authorisation regime applicable to financial services firms and authorised individuals associated with those firms? When is registration or authorisation necessary, and how is it effected?

The PRA and the FCA have the power to authorise a firm to carry on regulated activities under the FSMA (only firms authorised or exempt under the FSMA may carry on FSMA-regulated activities in the UK).

A firm must apply to the PRA if its application includes certain PRA-regulated activities, such as deposit-taking or the writing of insurance contracts. These firms will have their application considered by both the FCA and the PRA. In any other case the application will be made to the FCA only.

In the case of dual-regulated firms, the PRA leads the authorisation process. This includes pre-application meetings with the FCA and PRA; submission by the applicant of a detailed application pack including a core details form, a regulatory business plan, a controllers form, applications for certain key individuals (such as directors, senior managers and individuals responsible for compliance functions) to perform 'senior management functions' and an IT self-assessment questionnaire; and the payment of a fee ranging from £1,500 to £25,000 depending on the complexity of the application. The PRA and FCA must be satisfied that certain threshold conditions are met and that the firm will continue to meet certain minimum standards before granting any authorisation. The regulators must come to a decision within six months of the date it receives the completed application.

Applications to the FCA only follow a similar structure; however, the FCA has sole responsibility for the authorisation process.

Certain individuals performing key functions for authorised firms must also be pre-approved by the FCA or PRA (as appropriate). The senior managers regime applies to banks, building societies, credit unions, PRA-designated investment firms, insurers, and all other FSMA authorised firms other than benchmark administrators (although the senior managers regime will be extended to benchmark administrators from 7 December 2020). The senior managers regime extends to directors, partners, officers, senior managers and certain key employees (eg, the money laundering reporting officer and compliance officer). Applications for approval to perform 'senior management functions' must be made prior to the relevant individual's appointment, and the PRA and FCA have up to three months to determine an application.

A separate regime applies for payment services firms and e-money institutions. E-money or payment institution authorisation applications must be determined by the FCA within three months. In addition, firms that operate in lower risk environments, such as small e-money institutions and payments firms and consumer buy-to-let firms, may only need to be registered with the FCA.

Legislation

5 What statute or other legal basis is the source of each regulatory authority's jurisdiction?

The FSMA is the basis of the FCA's and the PRA's jurisdictions in respect of FSMA-regulated activities and firms. The PSRs and the EMRs are the basis of the FCA's jurisdiction in relation to the payment services and e-money regimes. Various elements of EU legislation also apply directly in the UK, and the FCA or PRA is empowered as the competent authority in relation to that legislation.

6 What principal laws and financial service authority rules apply to the activities of financial services firms and their associated persons?

The current regulatory framework in the UK derives largely from the FSMA and its secondary legislation. The main rules applicable to financial services firms are set out in a combination of directly applicable EU legislation (such as the Capital Requirements Regulation, which has recently been reviewed and amended at the EU level) and the handbooks and rulebooks of the FCA and the PRA. The regulators also set out regulatory expectations in non-rule based materials such as policy statements, approach documents, thematic review reports and speeches.

Scope of regulation

7 What are the main areas of regulation for each type of regulated financial services provider and product?

Firms performing regulated activities in the UK must generally be authorised by (or, for certain firms, registered with) one of the UK financial services regulators unless they benefit from an exemption or exclusion. Once authorised the requirements that apply vary depending on the types of regulated activities performed.

Most UK-authorised firms are subject to regulatory capital requirements, with banks, insurers and investment firms subject to the most stringent capital requirements.

Extensive regulatory rules and guidance also apply to regulated firms under the relevant UK legislation, as well as directly applicable EU laws and the PRA and FCA rules and guidance.

The PRA and FCA rulebooks encompass both high-level standards for conduct, and systems and controls of regulated firms, as well as a number of requirements relating to a firm's day-to-day business, such as the management of client assets or the disclosures required to be made to clients and counterparties.

UK-regulated firms are under a general duty to inform the UK regulators of a material change in their business, management or of any significant regulatory rule breaches or complaints. In addition, firms are typically required to comply with periodic reporting obligations in respect of their ongoing operations.

Non-FSMA derived rules also apply to UK-regulated firms, such as the UK Money Laundering Regulations 2017 (MLRs). The FCA is responsible for supervising ongoing compliance with the MLRs and both prosecuting offences under that legislation and taking enforcement action for a lack of adequacy of systems of controls to prevent money laundering.

Additional requirements

8 What additional requirements apply to financial services firms and authorised persons, such as those imposed by self-regulatory bodies, designated professional bodies or other financial services organisations?

Financial services firms and senior managers may be subject to the rules and regulations of other professional or self-regulatory bodies. Whether firms are subject to any such rules or regulations, and the nature of those rules or regulations, will depend on the specific firms and bodies in question.

ENFORCEMENT

Investigatory powers

9 What powers do national financial services authorities have to examine and investigate compliance? What enforcement powers do they have for compliance breaches? How is compliance examined and enforced in practice?

Both the FCA and the PRA have a number of powers to investigate and take disciplinary action against firms and individuals who breach regulatory and some legal requirements.

The FCA has significant powers of investigation and information-gathering, which it can exercise against authorised firms. These powers are set out in the FSMA, and include powers to:

- require information and documents from authorised firms and connected persons;
- require a report on an authorised firm by a skilled person (and in some cases to appoint that person); and
- appoint both general and specific investigators.

The FCA has a number of disciplinary and enforcement powers, the most commonly used being the ability to issue public statements and censure, and to impose financial penalties. The FCA can also:

- vary or withdraw a firm's regulatory permissions, and impose restrictions or suspensions on a firm's ability to carry on regulated activities;
- withdraw or suspend an individual's approval, or restrict them in, or prohibit them from, performing certain functions;
- apply to court for injunctions in connection with certain matters; and
- prosecute certain criminal offences, including insider dealing and money laundering offences.

The FCA's overall approach to enforcement is a strategy of 'credible deterrence' (ie, to deter firms or individuals being disciplined from reoffending and to deter others from making similar mistakes). The FCA has published guidance on its policies and procedures and its approach to enforcement in its Decision Procedure and Penalties Manual and its Enforcement Guide. During 2018, the FCA consulted on its approach to enforcement and published a feedback statement which emphasised the FCA's mission of making its approach to enforcement more transparent.

The PRA has broadly the same information-gathering powers as the FCA against PRA-authorised firms and connected persons, and can also require the provision of skilled persons' reports (and to appoint skilled persons) and appoint investigators.

Like the FCA, the PRA has enforcement powers, although it is only able to impose penalties on PRA-authorised firms. The PRA has published statements of policy and procedures detailing how it will exercise its powers to impose financial penalties and suspensions, or impose restrictions on firms or senior managers.

Disciplinary powers

10 What are the powers of national financial services authorities to discipline or punish infractions? Which other bodies are responsible for criminal enforcement relating to compliance violations?

See question 9. Various other bodies are responsible for compliance enforcement in the UK, depending on the relevant legal or regulatory requirement. For example, the Information Commissioner's Office is the regulatory authority responsible for enforcement of breaches of UK data protection legislation, while the Office of Financial Sanctions Implementation (part of HM Treasury) enforces financial sanctions in the UK.

Tribunals

11 What tribunals adjudicate financial services criminal and civil infractions?

The FCA and PRA each have an internal decision-making process that applies in the context of enforcement action.

The FCA's Decision Procedure and Penalties Manual provides guidance on the nature and procedure of the FCA's Regulatory Decisions Committee, which is (in most cases) responsible for deciding whether to take enforcement action following an investigation. In August 2018, the Bank of England introduced an Enforcement Decision-Making Committee in respect of contested PRA enforcement actions.

Decisions taken by the FCA or PRA may be appealed by firms and individuals to the Tax and Chancery Chamber of the Upper Tribunal of the High Court.

A criminal prosecution brought by the FCA or PRA would be instituted in the criminal courts in England, Wales or Northern Ireland.

Penalties

12 What are typical sanctions imposed against firms and individuals for violations? Are settlements common?

Typically, fines are levied by the PRA and FCA against firms for violations. Discounts are ordinarily applied where firms cooperate with the regulators and for early settlement. In 2019, the FCA imposed fines of approximately £392.3 million, including a fine of £102.17 million levied against Standard Chartered Bank for shortcomings in its anti-money laundering (AML) controls relating to customer due diligence and ongoing monitoring. This was the second-largest financial penalty for AML controls failings ever imposed by the FCA.

COMPLIANCE PROGRAMMES

Programme requirements

13 What requirements exist concerning the nature and content of compliance and supervisory programmes for each type of regulated entity?

Regulated firms are required to have in place systems and controls to ensure that they comply with applicable laws and regulatory requirements. The nature of these controls and compliance programmes varies depending on the size of the firm and the regulated activities performed.

Compliance requirements are set out in a combination of legislation, including, at the time of writing, directly applicable EU legislation, and in FCA and PRA rules and guidance. There are also a number of ways best practice may be conveyed to firms, including through ongoing supervision and as a result of thematic reviews undertaken by the FCA.

Gatekeepers

14 | How important are gatekeepers in the regulatory structure?

In recent years there has been a heightened focus on improving individual accountability for individuals working in financial services.

Senior individuals at FSMA firms performing certain key functions have to be pre-approved by the PRA and FCA pursuant to the senior managers regime. These functions broadly cover roles where individuals have managerial responsibility for a firm's affairs. Examples of individuals that need to be pre-approved include individuals performing executive director roles, the head of internal audit functions and compliance oversight. Financial institutions are expected to perform due diligence on prospective senior managers in advance of appointing these individuals. These approved individuals are subject to FCA or PRA conduct rules.

Directors' duties and liability

15 | What are the duties of directors, and what standard of care applies to the boards of directors of financial services firms?

In addition to the high-level requirements imposed on senior managers by the FCA or PRA, directors of financial institutions incorporated as companies in England are subject to high-level general and fiduciary duties set out in the Companies Act 2006 and common law. In particular, they are required to promote the success of the company, exercise independent judgement and exercise reasonable care, skill and diligence.

16 | When are directors typically held individually accountable for the activities of financial services firms?

Senior managers have a duty of responsibility under the senior managers regime. The FCA and the PRA can take action against senior managers if:

- they are responsible for the management of any activities in their firm in relation to which their firm contravenes a relevant requirement; and
- they do not take the steps that a person in their position could reasonably be expected to take to avoid the contravention occurring (or continuing).

The burden of proof lies with the regulator to establish that a contravention has occurred and that the senior manager did not take the steps that an individual in his or her position could reasonably be expected to take to avoid the contravention occurring. The FCA and the PRA have produced separate but largely consistent guidance outlining how a senior manager should behave to comply with their duties of responsibility.

The duty of responsibility for senior managers is supported by conduct rules, which prescribe a base level of good conduct for staff. The FCA's conduct rules in respect of individuals at firms subject to the senior managers regime are set out in the Code of Conduct source-book, and the PRA's rules are set out in the Conduct Rules Part of the PRA Rulebook. The duty of responsibility applies to all senior managers at all authorised firms (other than benchmark administrators, to whom the senior managers regime will be extended later this year). The regulators can take disciplinary action against individuals for non-compliance with the conduct rules.

Private rights of action

17 | Do private rights of action apply to violations of national financial services authority rules and regulations?

Section 138D of the FSMA establishes a statutory right for certain private persons who suffer loss as a result of contravention by an authorised firm of an FCA or PRA rule to bring an action for damages, subject to the defences for breach of statutory duty (such as contributory negligence). There is a presumption that breach of an FCA rule is actionable unless the rule states to the contrary, whereas a PRA rule must expressly provide that it is actionable.

Customers may also be able to bring claims against investment firms in contract or tort where there has been a breach of a regulatory rule or requirement, and courts may look to the scope of regulatory rules to inform the scope of common law duties owed by investment firms to clients.

Standard of care for customers

18 | What is the standard of care that applies to each type of financial services firm and authorised person when dealing with retail customers?

Financial services firms are subject to high-level requirements to treat their customers fairly and to act in the best interests of clients, and a high standard of care applies to financial services firms when dealing with retail customers. Categorisation as a retail client offers the most protection to customers and imposes the most requirements on financial institutions dealing with such clients in terms of communication, disclosure and transparency.

Retail clients also benefit from the additional protections offered by the Financial Ombudsman Service, a UK ombudsman that considers and settles disputes between consumers and financial services businesses, and the Financial Services Compensation Scheme, a UK compensation scheme for customers of insolvent UK financial services firms.

In addition, since January 2019 the UK has introduced a ring-fencing regime around retail deposits held by UK financial institutions. The aim of this is to separate certain core banking services critical to individuals and small and medium-sized enterprises from wholesale and investment banking services, in order to insulate retail customers and smaller businesses from the possible failure of the investment banking entity.

19 | Does the standard of care differ based on the sophistication of the customer or counterparty?

Yes. Both EU legislation (MiFID II) and the various UK regulatory regimes recognise that investors have different levels of knowledge, skill and expertise and that the regulatory requirements should reflect this.

For banks and investment firms, firms are required to categorise clients into retail clients, professional clients and eligible counterparties. Different regulatory protections apply for each of these categories, with those falling within the retail category – the less experienced, knowledgeable and sophisticated investors – afforded a higher level of protection than investors in the other categories.

In addition, the PSRs allow payment institutions to disapply some of the conduct and information requirements set out in the regulations when dealing with certain corporate clients.

Rule making

20 How are rules that affect the financial services industry adopted? Is there a consultation process?

At present, rules that affect the financial services industry in the UK encompass EU legislation, formal guidance issued by certain EU bodies such as European Supervisory Authorities, UK legislation and FCA and PRA rules and guidance.

The process for adopting rules and regulations, including whether a consultation is required and the manner of that consultation, depends on the nature of the rule being adopted. Generally, though, consultations are undertaken in respect of rules that will significantly affect the financial services industry.

In October 2019, the UK and the EU concluded negotiations on a draft agreement dealing with the UK's withdrawal from the EU (the Withdrawal Agreement) and a draft political declaration regarding the framework for the future relationship between the UK and EU. The Withdrawal Agreement had to be ratified by the UK parliament and the EU's political institutions before 31 January 2020 to avoid a no-deal Brexit. It was ratified by the UK parliament on 23 January 2020 and the EU on 29 January 2020. As the Withdrawal Agreement and accompanying political declaration were ratified by the UK and the EU, a post-Brexit transition period began under which, until 31 December 2020, the free movement of people will continue, and the UK will follow all EU rules and regulations and remain in the European single market and customs union. Provisions in the European Union (Withdrawal) Act 2018 will retain most existing EU law as a new body of UK law (referred to as 'retained EU law') after the transition period is complete. The UK will decide whether to reflect post-exit changes to EU law in UK law.

It is possible that the financial services industry will be affected by the terms of any longer-term free trade arrangement entered into between the UK and the EU, although such arrangements do not typically contain detailed provisions on financial regulation.

CROSS-BORDER ISSUES

Cross-border regulation

21 How do national financial services authorities approach cross-border issues?

During the post-Brexit transition period, European Economic Area-authorised financial institutions are still generally able to operate in the UK without the need for a separate authorisation pursuant to a cross-border services or a branch passport. This 'passporting' regime allows European Economic Area-authorised financial services firms to conduct business for which they are authorised in their home state in the UK and vice versa, without seeking a separate UK licence. Passporting is subject to a notification procedure between the EEA financial institution, the EEA home state regulator and the relevant UK regulator, which requires the home state regulator to verify that the firm meets certain specified conditions.

Foreign financial institutions incorporated outside the EEA are able to operate in the UK by establishing a UK-authorised branch or subsidiary, or alternatively may operate without a UK authorisation in reliance on certain overseas persons exemptions. The overseas persons exemptions allow overseas firms to provide certain financial services to UK customers on a cross-border basis, although the exemptions only apply to certain regulated activities (including dealing in investments, arranging transactions, advising on investments and certain mortgage related activities) and come with strict conditions preventing the overseas firm from having a physical presence in the UK.

Davis Polk

Mark Chalmers
mark.chalmers@davispolk.com

Jennifer Duffy
jennifer.duffy@davispolk.com

Simon Witty
simon.witty@davispolk.com

5 Aldermanbury Square
London
EC2V 7HR
United Kingdom
Tel: +44 20 7418 1300
Fax: +44 20 7418 1400
www.davispolk.com/offices/london/

International standards

22 What role does international standard setting play in the rules and standards implemented in your jurisdiction?

Generally the UK seeks to implement international standards. EU and international regulatory policy and standards, and their implementation, supervision and enforcement in the UK, are integral to the remits of the FCA and the PRA. The FCA also engages regularly with a wide range of European and international counterparts and stakeholders to enhance cooperation, share best practice and discuss issues of common interest.

UPDATE AND TRENDS

Current developments

23 Are there any other current developments or emerging trends that should be noted?

At the time of writing, it is difficult to predict the future of the UK's relationship with the EU. During the transition period, the UK and the EU have committed to negotiate a free trade agreement governing the terms of their post-Brexit relationship.

The European Commission has reiterated that financial institutions that wish to provide banking or insurance services in the EU after Brexit should take steps to be properly authorised by the date of withdrawal and following the expiration of the transition period, including by establishing a presence in the EU27. It may be that UK firms will be able to provide certain types of services to professional clients and eligible counterparties in the EEA after the transition period on the basis of equivalence. However, market access on the basis of equivalence is much more limited compared to the current passporting regime.

United States

Annette L Nazareth, Zachary J Zweihorn, Christopher M Paridon and Mark A Sater
Davis Polk & Wardwell LLP

REGULATORY FRAMEWORK

Regulatory authorities

1 What national authorities regulate the provision of financial products and services?

The structure of the regulatory regime for financial products and services in the United States is arguably the most complex of any jurisdiction, due to a variety of factors including historical precedent, the federalist nature of the US, and national politics. Recent changes since the financial crisis of 2008 were aimed at addressing regulatory gaps and systemic risk issues, although the financial regulatory structure has remained largely intact:

- Banking supervisors, market regulators and a consumer financial products agency have the authority to regulate the provision of financial products and services.
- Banks in the US may choose to be chartered at the state or federal level, and the applicable banking supervisor or supervisors depends on the charter type. The federal banking supervisors include the Board of Governors of the Federal Reserve System (the Federal Reserve), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Banking Regulators). The National Credit Union Association, which regulates credit unions, is outside the scope of this chapter.
- Financial products and services, financial markets and certain participants in those markets are regulated by the financial Markets Regulators. At the national level, these regulators include the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) (collectively, the Markets Regulators). In addition to these federal regulators, state authorities may also have jurisdiction to oversee certain products and services, although these supervisors are generally outside the scope of this chapter.
- The Consumer Financial Protection Bureau (CFPB) was formed in 2010 to focus on consumer protection with regard to financial products and services.

The complex array of supervisory agencies necessitates coordination between regulators.

2 What activities does each national financial services authority regulate?

The Banking Regulators are tasked with monitoring the safety and soundness of depository institutions, and supervising all activities of depository institutions within their jurisdictions. The OCC regulates national banks and federal thrifts, and the Federal Reserve and FDIC serve as the primary federal regulator for state-chartered banks and thrifts – the former regulating state-chartered banks that choose to be Federal Reserve members, and the latter regulating non-member banks and state-chartered thrifts. The FDIC also has a role in regulating all federal and state banks and thrifts, as the insurer of their deposits. Finally, in its capacity as the consolidated supervisor of bank and thrift holding companies, the Federal Reserve oversees the activities of institutions that control or are affiliated with banks or thrifts.

The SEC regulates the offer and sale of securities (which include securities options and security-based swaps), US securities markets and certain market participants such as securities exchanges, clearing agencies, broker-dealers, investment advisers and investment funds. The CFTC regulates activities relating to most non-security derivatives – primarily futures, options on futures and swaps. Persons regulated by the CFTC include, among others, futures exchanges, derivatives clearing organisations, futures commission merchants (FCMs), swap dealers, commodity pool operators and 'commodity trading advisors'.

The CFPB regulates consumer financial products and services, which include among others, extensions of credit, certain real estate settlement services, cheque cashing and financial data processing.

Many financial institutions are subject to multiple regulators to the extent that they engage in multiple financial activities or are part of a diversified holding company structure.

3 What products does each national financial services authority regulate?

The Banking Regulators exercise comprehensive supervisory oversight over the activities of depository institutions; however, certain Banking Regulators' rules apply specifically to certain types of products or activities (eg, consumer lending or fiduciary services).

The Markets Regulators regulate the offers and sales of financial products within their jurisdictions. The SEC regulates securities and does so primarily through a registration and disclosure regime and its anti-fraud authority. The SEC also focuses on investor protection and market integrity issues through rules that apply to intermediaries such as exchanges, broker-dealers and investment advisers. The CFTC regulates futures and swaps, among other derivative instruments. While most of the requirements relating to these instruments apply to registered entities, some apply more generally to users of these products (such as mandatory clearing for certain standardised swaps and, in some cases, swap trade reporting requirements).

The CFPB regulates consumer financial products and services, including deposit products, secured and unsecured loans, and prepaid cards.

Authorisation regime

4 What is the registration or authorisation regime applicable to financial services firms and authorised individuals associated with those firms? When is registration or authorisation necessary, and how is it effected?

To accept deposits, an entity must be chartered as a depository institution by either a federal or state authority. The choice of charter determines both the legal framework that will apply and the regulator that will supervise the institution. In choosing the appropriate charter, an entity will likely consider most heavily the restrictions imposed, and the activities permitted by laws and regulations applicable to a depository institution (or its affiliates) based on the charter type.

To receive a charter, a proposed depository institution must apply to:

- the appropriate regulatory authority (ie, the OCC for national banks and federal thrifts);
- state regulators (for state banks and thrifts); and
- the FDIC in order to obtain deposit insurance.

In addition, if the proposed bank or thrift is under the control of a parent company, the parent company must apply to the Federal Reserve to become a bank or thrift holding company. The application process requires the submission of extensive materials, including detailed business plans, pro forma financial statements, and biographies and financial reports for proposed shareholders, directors and officers.

With regard to the Markets Regulators, the registration regime depends on the particular activity engaged in by a firm. For example, unless an exemption applies, a firm will have to register with:

- the SEC as an investment adviser if it is engaged in the business of providing investment advice to others for compensation;
- the SEC as a broker-dealer if it is engaged in the business of effecting transactions in securities for the account of others or buying and selling securities for its own account, other than in an ordinary trader capacity;
- the CFTC as a swap dealer if it is engaged in swap dealing activities above a de minimis threshold; and
- the CFTC as an FCM if it solicits or accepts orders to buy or sell futures or options on futures and accepts money or other assets from customers to support such orders.

Many firms regulated by a Markets Regulator must also become members of a self-regulatory organisation (SRO), which are subject to oversight by the relevant Markets Regulator. For example, broker-dealers must generally become members of the Financial Industry Regulatory Authority (FINRA) and swap dealers and FCMs must become members of the National Futures Association (NFA).

Registration for firms involves submitting an application to the relevant Markets Regulator or SRO. The application requirements vary but will generally request information regarding the ownership of the applicant, certain prior criminal, civil or regulatory history, evidence of financial and capital adequacy, information relating to its proposed operations and compliance capabilities, among others. Certain firm personnel are also subject to individual licensing and qualification requirements.

Legislation

5 What statute or other legal basis is the source of each regulatory authority's jurisdiction?

Each of the primary financial regulators in the US was created by statute to address a national crisis or market event:

- The OCC was created by the National Bank Act of 1864 as part of an effort to create the financial infrastructure necessary to finance the American Civil War.
- The Federal Reserve System was established under the Federal Reserve Act of 1913 in response to instability in the financial sector best represented by the Banking Panic of 1907, and the Federal Reserve has additional jurisdiction over depository institution holding companies and their non-depository institution subsidiaries under the Bank Holding Company Act of 1956 and the Home Owners' Loan Act.
- The FDIC and the system of federal deposit insurance were created during the Great Depression under the Banking Act of 1933 (which has since been replaced by the Federal Deposit Insurance Act of 1950) in response to the panic and bank runs that accompanied the economic downturn.
- The SEC was initially established pursuant to the Securities Exchange Act of 1934 (the Exchange Act), following the stock market crash of 1929, to oversee the US securities market and has additional jurisdiction relating to the offer and sale of securities under the Securities Act of 1933 (the Securities Act).
- The CFTC was created in 1974 pursuant to the Commodity Futures Trading Commission Act. At the time, the predecessor to the CFTC generally regulated only agricultural commodities. The CFTC, however, was granted with the authority to regulate the growing trading in futures and options on non-agricultural commodities.
- The CFPB was established after the financial crisis of 2008 by the Consumer Financial Protection Act of 2010.

6 What principal laws and financial service authority rules apply to the activities of financial services firms and their associated persons?

The primary statute applying to national banks is the National Bank Act, which sets out the parameters for the activities in which national banks may engage. Bank holding companies and their non-bank subsidiaries are subject to activities limitations imposed by the Bank Holding Company Act of 1956. Federal thrifts and thrift holding companies are subject to the activities restrictions of the Home Owners' Loan Act. The activities of state banks and thrifts are primarily limited by state banking laws, but are also subject to federal limits set in the Federal Deposit Insurance Act. The Federal Reserve Act also imposes restrictions on the inter-affiliate activities of bank holding companies and thrift holding companies and their subsidiaries.

The primary statutes applying to financial services firms regulated by the SEC include:

- the Securities Act, which is generally designed to ensure that investors receive sufficient information regarding securities offered for public sale, and to prevent misrepresentations and other fraud in the sale of securities;
- the Exchange Act, which, among other things, authorises the SEC to regulate various securities market participants;
- the Investment Advisers Act of 1940 (the Advisers Act), which governs the regulation of investment advisers; and
- the Investment Company Act of 1940, which governs the regulation of investment companies, including mutual funds.

The primary statute applying to financial services firms regulated by the CFTC is the Commodity Exchange Act, which governs, among others, futures, options on futures and swaps, and certain persons that engage in activities with regard to those products.

The primary rules applying to financial services firms include the rules adopted to implement the foregoing statutes.

Scope of regulation

7 What are the main areas of regulation for each type of regulated financial services provider and product?

The principal areas of regulation for depository institutions and their holding companies include:

- activities restrictions;
- safety and soundness requirements;
- capital and liquidity requirements;
- lending restrictions;
- fiduciary regulations;
- consumer protection laws and regulations; and
- affiliate transaction restrictions.

For persons and entities regulated by the Markets Regulators, the principal areas of regulation include:

- registration requirements;
- capital and margin requirements;
- clearing requirements;
- business conduct standards;
- reporting requirements;
- requirements to adopt policies and procedures; and
- record-keeping obligations.

Additional requirements

8 What additional requirements apply to financial services firms and authorised persons, such as those imposed by self-regulatory bodies, designated professional bodies or other financial services organisations?

As described in question 4, many firms regulated by a Markets Regulator must also become members of an SRO, such as FINRA or the NFA, and certain firm personnel must register with the same SRO and pass a qualification examination.

Securities and derivatives exchanges and clearing organisations are also SROs. As a result, market participants that have direct access to such exchanges or clearing organisations must become members of these institutions and comply with their rules.

Requirements imposed by SROs on their members vary depending on the type of regulated entity and the type of SRO. In some instances, SRO rules implement existing federal statutory or regulatory requirements. In other cases, SROs are provided with discretion to adopt additional or more detailed requirements. FINRA, for example, in addition to enforcing the Exchange Act and SEC rules, imposes extensive obligations on all aspects of a broker-dealer's activities and requires its member broker-dealers to comply with 'just and equitable principles of trade', which is a higher conduct standard than the anti-fraud standard that the SEC can impose under the Exchange Act.

ENFORCEMENT

Investigatory powers

9 What powers do national financial services authorities have to examine and investigate compliance? What enforcement powers do they have for compliance breaches? How is compliance examined and enforced in practice?

The Banking Regulators, the CFPB, the Markets Regulators and SROs have broad authority to examine the entities they supervise (and, in some cases, their affiliates) for compliance with applicable laws, rules and regulations. They also have enforcement powers to address legal and regulatory violations. How these authorities are exercised in practice varies by regulator.

The Banking Regulators are prudential regulators, supervising institutions within their jurisdiction to monitor their safety and soundness, as well as their compliance with federal banking laws and regulations. Each of the Banking Regulators regularly conducts on-site safety and soundness examinations to assess the financial and managerial soundness of the regulated institution. In addition, the Banking Regulators conduct examinations that focus on compliance with particular legal and regulatory requirements, such as anti-money laundering laws or community investment and lending requirements. To address violations of laws or regulations or the finding of unsafe or unsound practices, the Banking Regulators may informally require regulated institutions to remediate or may bring formal enforcement actions.

The CFPB is a new federal agency formed in 2010, which has the authority to supervise and examine banking institutions with more than US$10 billion in assets, as well as their affiliates (unless excepted), for compliance with federal consumer financial protection laws. The CFPB has the authority to bring enforcement actions not only against institutions it supervises, but against any institution that engages in financial transactions with consumers, for violations of applicable federal consumer financial laws or for engaging in acts or practices that are deemed unfair, deceptive or abusive.

The Markets Regulators examine regulated institutions for compliance with applicable laws and regulations both directly and indirectly through examinations by the SROs – which conduct their own examination and enforcement activities. In addition, the Markets Regulators have the authority to conduct informal or formal investigations of potential misconduct and to bring enforcement actions. Such potential misconduct may come to the attention of the Markets Regulators through a variety of channels, including through examinations, complaints from the public or referrals from other government agencies. Markets Regulators and their related SROs are generally viewed as having more of an enforcement focus than the Banking Regulators.

Disciplinary powers

10 What are the powers of national financial services authorities to discipline or punish infractions? Which other bodies are responsible for criminal enforcement relating to compliance violations?

The Banking and Markets Regulators and the CFPB have civil enforcement powers and can pursue a variety of civil remedies.

The Banking Regulators have the power to pursue a variety of civil remedies, both informal and formal, against depository institutions and their affiliates, as well as associated individuals, for unsafe and unsound practices or compliance violations. Informal remedies include commitment letters, memoranda of understanding or the issuance of findings entitled 'matters requiring attention'. Formal remedies against firms may include cease-and-desist orders, formal written or supervisory agreements, prompt corrective action directives and civil money penalties. Formal remedies against individuals associated with depository institutions include removal and prohibition orders, cease-and-desist orders, restitution orders and civil money penalties.

The Markets Regulators have the power to seek a variety of civil remedies against both firms and individuals. Sanctions include injunctions or cease-and-desist orders, revocation or suspension of an individual's or entity's registration and exchange trading privileges, restitution orders, disgorgement of ill-gotten profits and civil money penalties. Certain industry and conduct-related bars may also be available.

SROs, such as FINRA and the NFA, also have authority to discipline infractions committed by their members in violation of the application statutes, SEC rules and their own rules. SROs generally have the authority to fine, suspend or bar individuals and firms from the industry, among others.

To the extent that regulated entities' or individuals' compliance failures constitute violations of criminal law, the Department of Justice, a US attorney's office or local law enforcement agencies may institute a criminal proceeding, either on their own initiative or upon a referral from the applicable Banking or Markets Regulator.

Tribunals

11 What tribunals adjudicate financial services criminal and civil infractions?

Federal district courts in the US adjudicate violations of both civil and criminal federal law. The Banking Regulators, the CFPB and the Markets Regulators may pursue civil violations of federal financial laws and regulations in the federal district courts, although the Banking Regulators generally elect to use administrative proceedings rather than court proceedings. Criminal financial services violations are also adjudicated in the federal district courts. To the extent that compliance failures constitute violations of state law, whether civil or criminal, such infractions would generally be tried in a state civil or criminal court, although federal courts may hear certain civil claims involving parties from different states.

The Banking Regulators, Markets Regulators and CFPB may also seek civil penalties and other remedies in administrative proceedings. Administrative proceedings are presented before administrative law judges, who may be employees of the particular financial services authority. These proceedings may result in non-judicial findings of fault or wrongdoing. Certain financial services authorities, such as the SEC, rely heavily on administrative proceedings, while others, like the Federal Reserve, use administrative proceedings less frequently.

Finally, SROs may institute disciplinary proceedings against members that are heard before their own internal bodies, although these may ultimately be appealable to the Markets Regulator itself.

Penalties

12 What are typical sanctions imposed against firms and individuals for violations? Are settlements common?

The majority of enforcement actions pursued by the Banking and Markets Regulators are resolved via settlement, including through cease-and-desist orders, removal and prohibition orders, civil money penalties, and disgorgement orders. The size of monetary sanctions imposed in a given case ranges significantly depending on the nature of the case. The largest penalties tend to be imposed in settlements in which the respondent knowingly violated the law and caused a pecuniary loss as a result.

In addition to imposing penalties, the Banking and Markets Regulators often require settling institutions to undertake substantial remediation efforts to improve policies, procedures, controls and governance, among other things, to mitigate the risk that the activity giving rise to the settlement will reoccur.

A unique and often-criticised aspect of the US financial regulators' settlement practices is the ability of respondents to settle with the regulators without admitting wrongdoing. Commonly referred to as 'neither-admit-nor-deny' settlements, the Banking and Markets Regulators justify this practice by asserting that it allows them to impose consequences on respondents quickly and obtain necessary relief for victims, while also avoiding burdensome litigation costs.

COMPLIANCE PROGRAMMES

Programme requirements

13 What requirements exist concerning the nature and content of compliance and supervisory programmes for each type of regulated entity?

The Banking Regulators, who act as prudential supervisors, are focused on monitoring the safety and soundness of depository institutions and their holding company system in a comprehensive manner. Thus, the Banking Regulators expect supervised institutions to adopt an effective risk-management programme that manages compliance risk alongside the other risks present in an institution's business. As a general matter, the Banking Regulators expect that a regulated institution's risk-management programme will reflect its size, resources and complexity, and will be proportionate to the risks present in its business.

No matter the size of the entity, an effective compliance programme for entities subject to the Banking Regulators' supervision will include among other features:

- adequate policies and procedures to safeguard and manage assets;
- a clear organisational structure that establishes responsibility for monitoring adherence to established policies;
- controls that facilitate effective assessment of risks; and
- an internal audit system.

The Markets Regulators have similar requirements for the content of their regulated entities' compliance programmes, although the precise expectations may depend on the type of regulated entity. In general, the Markets Regulators, either directly or through SRO rules, require their regulated institutions to:

- adopt and implement written policies and procedures reasonably designed to prevent violations of applicable law;
- periodically review the adequacy and effectiveness of such policies and procedures; and
- designate a chief compliance officer to administer such policies and procedures and regularly evaluate their effectiveness.

Gatekeepers

14 How important are gatekeepers in the regulatory structure?

The national financial services authorities place great emphasis on internal gatekeepers, such as chief compliance officers (CCOs), internal auditors, risk-management personnel and others who have a general obligation to identify and prevent potential misconduct.

As discussed above, regulatory expectations for risk management in depository institutions vary depending on a regulated institution's size, resources and complexity. Currently, national banks and federal thrifts with more than US$50 billion in consolidated assets are expected to implement a 'three lines of defence' risk-management programme, which requires the business line to assume first-line responsibility for compliance, an independent risk-management function headed by a chief risk executive (second line), and an independent audit function headed by a chief audit executive (third line). In this structure, the chief risk executive and chief audit executive have unrestricted access to the institution's board of directors. In large institutions, the second and third lines of defence are crucial for monitoring and assessing the institution's activities, as well as recommending areas for improvement. The Banking Regulators often look to second- and third-line reports as part of their own examination processes.

The Markets Regulators similarly place great emphasis on internal gatekeepers. Since the financial crisis, regulations have assigned additional responsibilities and increasing accountability to such personnel through periodic certifications. For example, the CFTC adopted a rule

requiring CCOs of FCMs and swap dealers to take reasonable steps to ensure compliance with applicable rules, and prepare and sign an annual report that provides an assessment of the effectiveness of the firm's policies and procedures, and describes any material non-compliance issues identified and the corresponding action taken. This report must also include a certification by the CCO or chief executive that the information contained in the annual report is accurate and complete in all material aspects. Markets Regulators also view their regulated institutions as themselves acting as gatekeepers to the industry, and in some cases expect them to surveil for and prevent misconduct by third parties using their services.

Directors' duties and liability

15 What are the duties of directors, and what standard of care applies to the boards of directors of financial services firms?

State corporate laws and common law generally govern the duties of the directors of US corporations, including financial services firms. Directors are ultimately responsible for the overall direction and strategy of the firm. A board carries out this responsibility primarily by setting the 'tone at the top' and selecting, retaining and overseeing the firm's managers, who direct daily operations. The board retains, however, the responsibility to evaluate and approve major decisions in the life of the firm.

When carrying out their responsibilities, directors of a US corporation owe the firm and its stockholders certain fiduciary duties, namely, the duties of care and loyalty. The duty of care generally requires directors to act with the care that a reasonably prudent person in a like position would use under similar circumstances. The duty of loyalty generally requires directors to act in good faith and in the best interests of the firm and its stockholders (and not for their own interests). In general, the business judgment rule applies to protect directors from judicial second-guessing when they have acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.

Bank directors may be held to a heightened standard with regard to these fiduciary duties, as courts have found that they must be concerned with the welfare of depositors as well as stockholders.

In addition to these general corporate responsibilities, the Banking and Markets Regulators have issued rules and guidance outlining specific responsibilities of boards of directors of financial institutions, which can be extensive.

16 When are directors typically held individually accountable for the activities of financial services firms?

Directors of financial services firms may be held individually liable (to shareholders or the applicable regulator) if they breach their fiduciary duties; however, as described above, the business judgment rule applies to protect directors from judicial second-guessing when they have acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.

In addition to being held accountable for breaches of fiduciary duties, directors of depository institutions could be subject to enforcement actions brought by the Banking Regulators for violating federal banking laws or engaging in unsafe or unsound practices, with the degree of the penalty – and the likelihood of an enforcement action – heightened depending on the director's mens rea and the extent of the consequential loss to the bank or pecuniary gain or benefit to the director. In addition, if a director of a national bank knowingly violates, or knowingly permits officers or agents of a bank to violate, federal banking laws, the bank could be dissolved and the director could be held liable in a personal and individual capacity for all damages that the bank, its shareholders or others may have sustained as a consequence of the violation.

Directors of financial services firms that are regulated by the Markets Regulators are considered to be 'control persons' and, as a result, may be held personally liable for the acts of the controlled entity if he or she failed to act in good faith or otherwise knowingly induced or engaged in the acts constituting the violation.

Private rights of action

17 Do private rights of action apply to violations of national financial services authority rules and regulations?

Whether a private right of action would or likely could exist for a violation of a national financial services authority statute or rule depends on the particular statute or rule at issue and how courts have interpreted them. Generally, a private right of action is available only where such a right is provided for in the statute or rule that is alleged to have been violated. Even where a private right of action is not specifically enumerated in a statute or rule, courts have occasionally found private rights of action to be implied based on legislative intent and other factors. Most financial services authority rules and regulations, however, have not been found to carry private rights of action.

Standard of care for customers

18 What is the standard of care that applies to each type of financial services firm and authorised person when dealing with retail customers?

The standard of care that applies when dealing with retail customers varies by the type of financial services firm and, in some cases, the particular capacity in which the financial services firm is servicing the customer.

Depository institutions must take care not to engage in unfair, deceptive or abusive acts or practices (UDAAPs) in any interaction with retail customers. These terms have been interpreted by the Banking Regulators, the CFPB and courts, which have developed tests for determining if an activity rises to the level of a UDAAP. The Banking Regulators only have the power to take action against depository institutions that conduct unfair or deceptive acts or practices. The CFPB has the full complement of powers and can take action against UDAAPs. There are also a multitude of laws and regulations that relate to the delivery of specific products and services by depository institutions, many of which are designed to protect the consumer.

Generally, depository institutions are not subject to fiduciary duties with regard to retail customers, unless they are acting in a fiduciary capacity (eg, a trustee or executor), in which case, state law governing duties owed by a fiduciary or, in some cases, federal law, may apply.

SEC-registered investment advisers are deemed fiduciaries under the Advisers Act and must accordingly comply with the duties of loyalty and care when interacting with all of their customers, including retail customers. The SEC and courts have interpreted these fiduciary duties as requiring investment advisers to act with utmost good faith in the best interests of their clients, make full and fair disclosure of all material facts, and employ all reasonable care to avoid misleading clients. The Advisers Act imposes further limitations on an investment adviser's dealings with customers.

Broker-dealers are generally not considered fiduciaries, although they nevertheless are subject to a duty of fair dealing. This duty is derived from common law agency principles and the anti-fraud provisions of the federal securities laws, and is also reflected in SRO rules. For example, FINRA requires its member broker-dealers to observe high standards of commercial honour and just and equitable principles

of trade. In addition, broker-dealers must comply with other requirements that affect how they interact with customers, including:

- suitability and 'best interest' requirements, which generally require broker-dealers to recommend only those specific securities or overall investment strategies that are suitable for their customers or (effective June 2020) in the case of retail investors, securities or investment strategies that are in the best interest of the retail investor, without putting the interests of the broker-dealer ahead of the customer; and
- the duty of best execution, which generally requires broker-dealers to seek to obtain the most favourable terms available under the circumstances for their customer orders.

19 Does the standard of care differ based on the sophistication of the customer or counterparty?

Banks acting as fiduciaries and SEC-registered investment advisers must exercise their fiduciary duties, including the duties of loyalty and care, no matter the sophistication of the customer or client. The standards for satisfying their fiduciary duties, however, may become more stringent as the sophistication decreases, as care that is reasonable when dealing with an institutional investor may not be reasonable when dealing with a retail customer.

Other aspects of US financial services rules and regulations may apply differently depending on the characteristics of a customer that serve as a proxy for sophistication. For example, a broker-dealer recommending a security to an 'institutional account' may qualify for an exemption from its obligation to conduct a customer-specific suitability analysis provided specified conditions are met. Similarly, effective June 2020, recommendations to retail investors are subject to the heightened 'best interest' standard.

Rule making

20 How are rules that affect the financial services industry adopted? Is there a consultation process?

The Banking and Markets Regulators are federal agencies and, thus, are subject to the US Administrative Procedure Act (APA), which sets out the process by which agencies may promulgate rules. These agencies generally use the APA's notice-and-comment process to promulgate rules pursuant to either their general statutory rulemaking power, or an express statutory directive.

To initiate the notice-and-comment process, the agencies issue a notice providing the public a draft of a proposed rule and explaining the statutory authority and purposes for that rule. The public is given a period of time – typically 60 to 90 days – to review and comment on the proposed rule. Agencies may also meet with financial institutions or trade associations to discuss the proposed rule and comment letters.

After considering the comments submitted, the regulators may issue final rules, which typically become effective 60 days to one year after the final rule is issued. Any person with standing to challenge the rule in court may do so on certain stipulated grounds, including by bringing a claim that the agency acted in an arbitrary and capricious manner. SRO rulemaking is also indirectly subject to the APA. For example, FINRA rules must be approved by the SEC, and therefore the SEC promulgates these proposed SRO rules for notice and comment before they may take effect.

CROSS-BORDER ISSUES

Cross-border regulation

21 How do national financial services authorities approach cross-border issues?

The way in which the Banking and Markets Regulators approach cross-border issues varies by type of financial services firm and, in some cases, the type of activity. In many cases, the applicable statute takes a territorial view when drawing the perimeter of US regulatory jurisdiction. For example, unless an exemption applies, a non-US entity will generally need to obtain a bank charter, establish a bank branch, agency or representative office, or register as a broker-dealer if it solicits banking or broker-dealer services to persons located in the US or engages in such activities within the US. A non-US entity could, however, provide banking or broker-dealer services to persons located outside the US without triggering the application of US banking and broker-dealer laws, respectively, so long as the interactions with the customer occur outside the US. Other categories of registrants, however, such as investment advisers and swap dealers may be required to register with the SEC or CFTC, respectively, if they provide services to US persons, regardless of their location.

With regard to certain cross-border transactions, the Banking and Markets Regulators have adopted exemptions and mutual recognition frameworks. For example, the Bank Holding Company Act of 1956 broadly exempts non-US activities of non-US banks, and under the uncleared swap margin rules adopted by the Banking Regulators and the CFTC, certain non-US swap dealers with regard to some swap transactions are permitted to comply with such rules by complying with the margin rules of another jurisdiction, if the applicable US regulator issues a determination that such other jurisdiction's rules are comparable to the US requirements. With regard to broker-dealer registration, non-US firms may be permitted to engage in limited activity in the United States without US registration pursuant to exemptions, including in some cases where the non-US firm is 'chaperoned' by a US registered broker-dealer.

International standards

22 What role does international standard setting play in the rules and standards implemented in your jurisdiction?

The Banking and Markets Regulators actively participate in international standard-setting organisations. For example, the Banking Regulators are members of the Basel Committee on Banking and Supervision, an international forum focusing on banking supervisory matters; the Federal Reserve and the SEC are members of the Financial Stability Board, an international body that promotes international financial stability; and the SEC and CFTC are members of the International Organization of Securities Commissions (IOSCO), a multilateral organisation that develops and promotes adherence to internationally recognised standards for securities regulation.

While the agreements reached by these international organisations are not self-executing, the Banking and Markets Regulators may implement the agreed-upon standards by promulgating rules pursuant to their general statutory grants of authority.

UPDATE AND TRENDS

Key developments of the past year

23 Are there any other current developments or emerging trends that should be noted?

Effective from 30 June 2020, the SEC adopted Regulation Best Interest, which heightens the standards that broker-dealers must maintain towards retail investors when making recommendations about securities or investment strategies.

Effective from 31 December 2019, the Federal Reserve finalised its rules to further tailor the enhanced the prudential standards and the US Basel III capital and liquidity requirements applicable to US and non-US banking organisations. These rules implemented section 401 of the Economic Growth, Regulatory and Consumer Protection Act of 2018 by increasing the minimum asset threshold for applicability from $50 billion to $100 billion and tailoring enhanced prudential standards and US Basel III capital and liquidity standards for banking organisations with $100 billion or more in total consolidated assets. Under the final rules, there are four main categories of banking organisations determined by size and other risk-based indicators, The type and content of enhanced prudential standards increasing in stringency as one moves from Category IV (lowest risk) to Category I (highest risk). The final rule provides non-US banking organisations some relief by focusing some enhanced prudential standards based solely on the thresholds and risk-based indicators of a non-US banking organisation's US intermediate holding company instead of its combined US operations (which includes its branches and agencies), and it also provides modest reporting relief for banking organisations.

Effective from 1 January 2020 and with compliance to occur no later than 1 January 2021, the Banking Regulators and Markets Regulators implemented changes to the proprietary trading and compliance programme provisions of final regulations implementing section 13 of the Bank Holding Company Act of 1956, commonly referred to as the 'Volcker Rule'. These changes modified the substantive and compliance programme obligations of banking entities as determined by their level of applicable trading assets and liabilities. Consistent with statutory changes, these rules also clarified that community banks are largely exempt from the Volcker Rule.

Davis Polk

Annette L Nazareth
annette.nazareth@davispolk.com

Zachary J Zweihorn
zachary.zweihorn@davispolk.com

Christopher M Paridon
chris.paridon@davispolk.com

Mark A Sater
mark.sater@davispolk.com

901 15th Street, NW
Washington, DC 20005
United States
Tel: +1 202 962 7000
Fax: +1 202 962 7111

450 Lexington Avenue
New York, NY 10017
United States
Tel: +1 212 450 4000
Fax: +1 212 701 5800

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