Second wave changes: Past lessons will help firms with 2022's regulatory challenges

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Tim Hitchcock

New Year is always a time to reflect and look ahead, but the 2021-2022 border is a particularly interesting vantage point. In the mid- to late-2010s, a swathe of European regulations expanded the breadth and depth of regulation. Now many EU rules from that era are being revised and the reach of regulation is being extended again in response to diverse challenges from climate change to crypto-finance.

Among the revisions affecting familiar regulatory areas are European Commission proposals, published in November, for a directive amending the revised Markets in Financial Instruments Directive (MiFID II) and its related regulation. At the same time, the Commission proposed changes to the Alternative Investment Fund Management Directive (AIFMD) 2011/61 and the Undertakings for Collective Investment in Transferrable Securities Directive (UCITS) 2009/65.

In the UK, plans taking forward proposals in its wholesale markets review are expected early in 2022.

'Quick fix'

The EU has already introduced 'quick fix' MiFID II amendments, which will apply from February 28, 2022. A UK quick fix of its onshored version of the directive (UK MiFID) came into effect via Treasury statutory instrument in July 2021. Financial Conduct Authority (FCA) policy statement PS21/20 added further changes, removing best execution reporting under regulatory technical standards (RTS) 27 and 28 from December 1, 2021 and exempting research on small and medium-capitalisation enterprises from UK MiFID's inducement rules from March 1, 2022.

Both EU and UK anti-money laundering/counter-terrorism funding (AML/CTF) frameworks are being overhauled. EU proposals include establishing a new authority to supervise AML/CTF at EU level, a new AML/CTF regulation and replacing the current fourth money laundering directive (AMLD4), amended by the fifth (AMLD5) with an even stronger, sixth iteration (AMLD6). The European Banking Authority issued new guidelines on risk-based supervision of AML/CTF on December 16.

The results of a UK Treasury review of AML/CTF arrangements are due by June 2022 with a separate statutory instrument amending the money laundering regulations due this spring. Even before regime changes in either jurisdiction, firms will likely face increased regulatory scrutiny over AML and market abuse in the year ahead, said Deborah Hutton, head of asset management and financial regulation at the lawyers Eversheds Sutherland in County Dublin.

"Interestingly, more issues have been identified but fines are decreasing as entities seem to be improving their overall risk and compliance policies and procedures," Hutton said. "We expect to see an increase focus as indicated by European Securities and Markets Authority in the asset management and fintech sectors."

Fresh complications

UK firms face a new consumer duty, consultation on which (FCA CP21/36) opened in December with a policy statement issuing rules scheduled for summer 2022. Firms should also expect fresh complications to arise as a result of Brexit, Hutton said.

"Despite the UK withdrawal from the EU on January 31, 2020, relations and arrangements between the EU and UK in relation to financial services are being developed," Hutton said. "Interaction will continue to create a number of challenges."

This sketched outline may suggest that traditional areas of regulation will preoccupy firms but major challenges could arise from newer fields. Climate change and other environmental social and governance (ESG) reporting requirements are set to increase in the EU and UK. The EU's Taxonomy Climate Delegated Act takes effect in January and the delayed Sustainable Finance Disclosure Regulation (SFDR) RTS in July. The new International Sustainability Standards Board may consult on proposed standards as early as the spring.

Cyber security and IT system stability are a growing regulatory concern. In November, the EU's proposed Digital Operational Resilience Regulation (DORA) inched closer to fruition when the negotiation stage between the European Council and Parliament commenced. New UK operational resilience rules in FCA policy statement PS21/3 and Prudential Regulation Authority PS6/21 take effect from March 31, 2022.

On top of all this, and perhaps of the greatest medium-term significance, regulators internationally are moving to catch up with developments in the crypto-sphere. Decentralised finance and stablecoins are particular concerns. In response, several jurisdictions are considering creating central bank digital currencies, which could have their own downsides for some firms.

Challenging old orthodoxy

"Traditional banking models will come under increased challenge by fintechs," Hutton said. "This is a theme that we are seeing across the EU."

All in all, compliance specialists will have to master simultaneous developments in several very different areas. Some, such as climate change and cyber-security, require drawing on expert knowledge from outside the function. Firms should respond to this challenge in a proportionate way, said Abi Reilly, a managing consultant at Bovill, a regulatory consultancy.

"It's dangerous to think compliance must know all about everything," Reilly said.

"With specialisms like climate change and cyber-security, compliance should act as a middleman between senior management and the experts. Conduct transparency and due diligence, and ensure you know about vulnerabilities and that they are addressed. Most compliance functions are busy firefighting anyway. Where larger firms have more capacity, it's used horizon scanning, determining the regulators' direction of travel."

Many compliance teams will be far better equipped for 2022's kaleidoscopic challenges than their counterparts were for Europe's mid-2010s regulatory sea change in reaction to the financial crisis.

Implementation of the fourth Capital Requirements Directive in 2014 introduced the Basel III standards with added remuneration rules.

Solvency II, the Market Abuse Regulation, the UK's Senior Managers and Certification Regime (SMCR) and the Brexit vote came in 2016. 4MLD applied from June 2017; MiFID II and the General Data Protection Regulation followed in early 2018.

'Drab nitpickers'

Early 2010s compliance functions usually lacked the headcount, resources and range of skills to absorb reforms of this scale without making changes themselves. There was also an image problem that often undermined relationships with senior management and front office personnel. Too many people regarded the function as a business-blocking nuisance and its practitioners as drab nitpickers.

"The workload went up and it was a stretch for compliance teams to keep ahead of developments," said Reilly, who spent more than 15 years working in compliance at a major European investment bank before joining Bovill.

"Several of the new regimes, especially MiFID II, make wholesale changes across several workstreams. Large firms increased headcount but smaller ones struggled and often turned to consultants. Just reading all the regulatory material would have been a stretch for one person."

Firms felt obliged to increase headcount because the penalties for breaching the new regimes were potentially severe and regulators were taking firmer line, especially the then new FCA.

Banks dashing to recruit compliance and AML staff started a hiring frenzy in 2014 that lasted into 2018 after asset managers joined in. Talent shortages forced practitioners' pay up, with salaries for new hires commonly rising 50% in 2015 and occasionally doubling. Now that they were paying far more for compliance and it had an important role preventing expensive breaches, firms' expectations of the function increased.

Compliance and AML staff were expected to be more involved in day-to-day business and to have good interpersonal skills so they could convey concerns to front-office managers.

"Bigger firms, especially those who'd fallen foul of regulators, were ahead of the curve and saw the way the world was going," Reilly said.

"They realised they needed a more collegiate relationship between departments and had to resource compliance with intelligent senior people who were the equivalent of their senior sales teams. Compliance officers needed to take senior managers with them and you can only do that if you command respect. Firms began hiring people who were articulate as well as intelligent and, frankly, had chutzpah."

Complaints Procedure

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