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AROUND THE CORNER

Financial Services Regulation in 2018

Introduction

Internationally, 2017 was a year either of waiting or of preparation for regulatory change. 2018 sees the entry into force of a wave of new regulation which firms need to both comply with and, where relevant, position themselves to benefit from.

In this report, practitioners from across our Global Financial Services Regulatory Group look at what more to expect from 2018. We start with the common themes that impact our clients across the globe, before focusing on developments in Europe, Asia- Pacific and North America in turn.

We hope you find the report a helpful guide to what's on the horizon, and look forward to working with you.

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Chair, Global Financial Services Regulatory Group

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Global Themes in 2018

Implementation:

Internationally, 2017 was a year either of waiting or of preparation for regulatory change. 2018 sees the entry into force of a wave of new regulation, especially in Europe and Asia-Pacific, which firms need to both comply with and, where relevant, position themselves to benefit from (eg, measures facilitating increased competition and innovation).

Regulatory burden:

Europe and Asia-Pacific continue to increase regulation while in contrast, the US is looking to re-examine post-crisis regulation to make it work better and do away with unnecessary or excessive regulation.

International cooperation:

Central authorities and supervisors are reaching agreement over prudential standards and, being most welcome, arriving at accommodations over conflicting market rules.

FinTech:

This is a growing international phenomena, as countries scramble to update their regulation in the light of rapid technological change, but also to facilitate their firms' changing business models.

Financial crime:

The trend toward increasing transparency of beneficial ownership, improving the efficacy of due diligence and promoting information sharing continues. This may result in more enforcement and higher penalties.

Global Themes in 2018... a closer look

We look at these themes in more detail and then at specific developments in Europe, the US and Asia-Pacific.

Implementation

Europe is rolling out new regulation on investment services, financial markets and payments, but the uncertainty over cross-border business post-Brexit between the UK and the EU-27 continues. At least a hard Brexit looks less likely after the first, and successful, phase of Brexit negotiations with an increased likelihood of a transitional period. In the US, as President Trump completes his first year in office, we are beginning to see the impact of his administration's de-regulation agenda. This is partly due to the placement of appointees at the heads of federal agencies, one of the main levers to effect change available to a president. Steps to dismantle aspects of Dodd-Frank are also gathering pace, yet much depends on what Congress will agree to.

The picture is similar in the Asia-Pacific region, with much of the rule-making already completed in previous years.

> *The next 12 months will likely focus on implementation and supervision rather than the creation of more regulation.*

Burden of regulation

Where there does seem to be divergence is over the direction of travel, ie, whether to increase or reduce regulation.

> *Generally, Europe and Asia-Pacific in the long aftermath of the 2008 financial crisis are still increasing*

The EU's MiFID2 market and investments legislation is a prime example, which sees the reporting burden significantly increased on firms and trading venues. The creation of product intervention powers in the EU and Australia to protect customers from inappropriate products and selling practices is another instance. On the macro scale, on 1 January 2019, the UK will implement its structural reform programme for the largest banks, ring-fencing their retail banking businesses from their investment and proprietary trading activities. The EU has been pursuing its own Liikanen proposals, although this no longer features in its 2018 Work Programme.

In contrast, the Trump agenda (see below), Congress willing, is going in the other direction. The US implemented the G-20 reforms rather more quickly than the EU and, if it does have buyer's remorse, this may be experienced in due course by the EU. Some evidence of this may be the deregulatory reforms in the proposed EMIR2 legislation. Brexit may also bring some deregulation in the UK, but not until the expiry of any transitional period. It may also be tempered by the need to maintain equivalence with EU regulations as a condition of future market access. Will the US gain an economic advantage and will Europe and Asia-Pacific turn and follow suit in due course?

International cooperation

The G-20 Summit of 2009 in Pittsburgh sought to increase transparency and stability in markets after the financial crisis. While the US enacted Dodd-Frank in response several years ago, 2018 sees implementation of MiFID2 in Europe, the continuing phase-in of EMIR derivative clearing and margining requirements, as well as proposed EMIR2 amendments.

> *Both the US and the EU are edging closer to cooperating where their markets interact.*

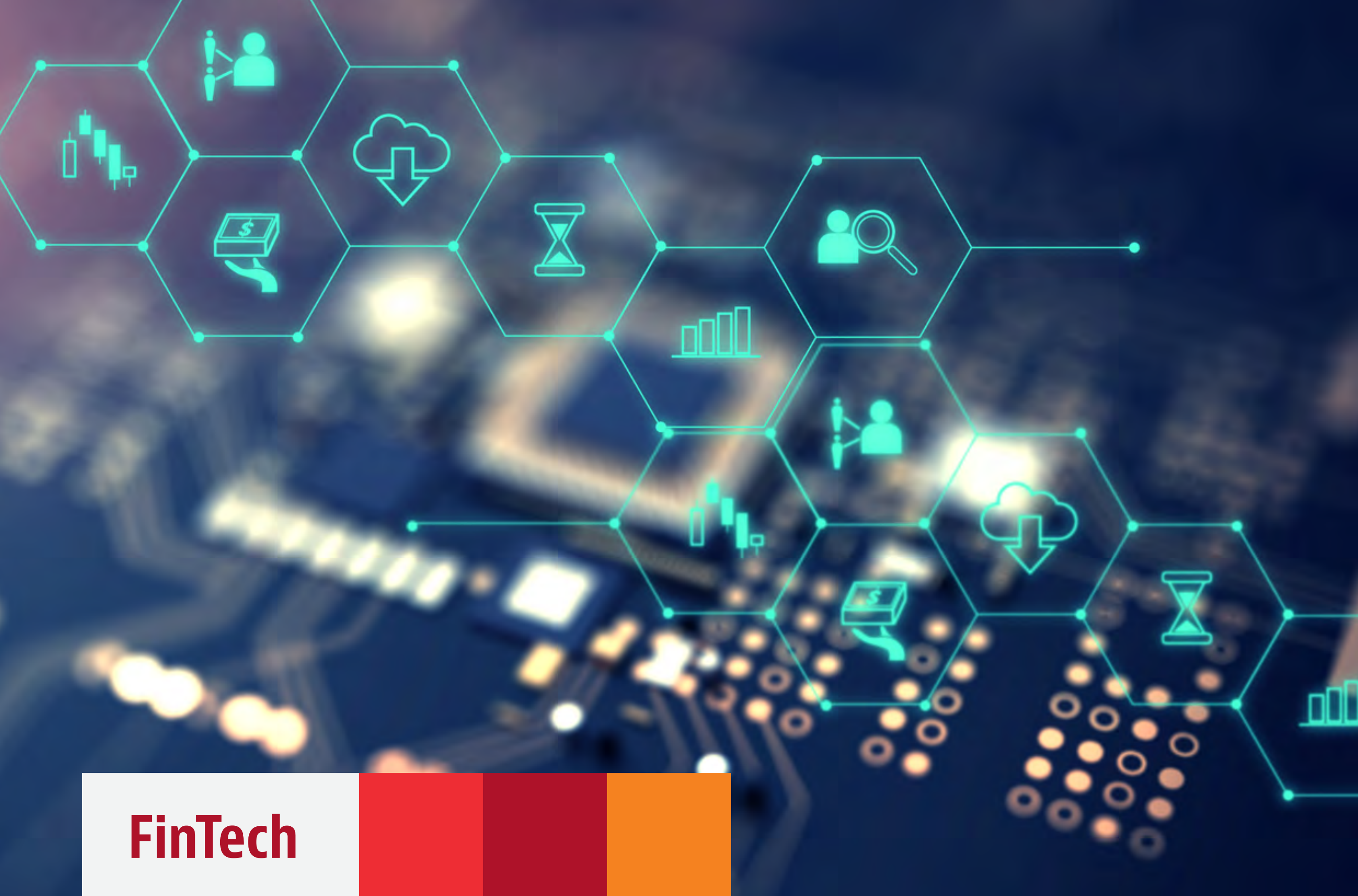
Most recently, this has taken place over third-party investment research with the grant of waivers by the US Securities and Exchange Commission (SEC) to US investment brokerages overpaid for research and, in turn, the European Commission's clarifying guidance to EU investment firms.

Asia-Pacific jurisdictions have, to varying degrees, been working toward implementing internationally agreed standards in order to meet scheduled deadlines. Implementation of over-the-counter (OTC) derivatives reform continues with most Asia-Pacific member jurisdictions establishing comprehensive trade reporting requirements and central clearing standards. Progress on implementing margin requirements for non-centrally cleared derivatives and platform/exchange trading has been somewhat slower.

On a regional scale, Asia-Pacific economies have made remarkable advances in strengthening collaboration to drive forward regulatory and capital market reform, particularly without the benefit of a single overarching authority like the EU to oversee harmonisation of regional agreements.

Further progress in terms of regulatory alignment has been made as regards variation margin of uncleared physically settled FX forwards. The European Supervisory Authorities (EBA, EIOPA, ESMA – or ESAs) have published a draft amendment to the EMIR margin rules with the aim of aligning the treatment of variation margin for such transactions with the supervisory guidance in other key jurisdictions, the US in particular. It is anticipated that this amendment will pass through the EU legislative process smoothly and, until such time, where one of the counterparties is a non-financial institution, the ESAs have advised national regulators to apply the EU framework to such transactions in a risk-based and proportionate manner, signalling a degree of leniency in their enforcement.

In December 2017, agreement was finally achieved to strengthen banks' capital requirements. While Basel 3 increased the amount of capital that banks must hold, so-called "Basel 4" looks to improve its quality and to do so prescribes how risk weighted assets are calculated. European banks will be affected to a greater extent because they have more non-performing loans and exposure to mortgage/property lending. This may incentivise their use of securitisation of loan books in future. Speculation that the Trump administration might pull out came to naught and this may show a greater appetite for internationalism than previously thought, or simply that this agreement was seen to be in US interests. However, it is not over. US congressional approval for the deal is still required, implementation is not due before 2022 and, even then, there is a five-year transitional period. Throughout the Asia-Pacific region, the first wave of Basel 3 standards has been implemented on time and in some cases ahead of the major economies. Progress on the second wave rules, however, is expected to be delayed due to decreased momentum in international markets.



FinTech

FinTech is a growing international phenomenon. What will the stance of regulators be and to what extent will regulation keep up? A good example is Initial Coin Offerings (ICO), which may be used as a means to raise funds from the public in exchange for a virtual currency. Whether they are subject to regulation is being decided on a case-by-case basis and...

> *..the position taken by regulators globally is still uncertain and inconsistent (though in some jurisdictions, such as the U.S. it's trending strongly toward regulation)..*

– see below for more detail. Increasingly, regulators are taking steps to facilitate products and services that harness new technologies. A number of jurisdictions have followed the example set by the UK's Financial Conduct Authority by establishing their own regulatory "sandboxes" to facilitate testing and authorisation of innovative technology. The US and Japan are the exception. For the US, the absence of a sandbox may be due to the multiplicity of federal and state agencies that would need to be involved and, of course, it has Silicon Valley instead. While not yet realised, Japan's government recognises the value of implementing a sandbox testing space to promote innovation and has indicated it may trial a regulatory sandbox as early as this Spring.

On a related theme, we can see regulation catching up with technology; the implementation of the EU's PSD2 legislation, which regulates new payment services that have the potential to disintermediate banks and card payment businesses, is illustrative. Singapore's proposed Payment Services Bill is in a similar category.

Financial Crime

> *All regions are strengthening their anti-money laundering and counter-terrorist legislation...*

...and seeking to improve transparency over beneficial ownership. This is indicative of a populist political agenda, the maximisation of tax revenues and the setting of international standards by the Financial Action Task Force. A particular spur to action is the emergence of unregulated, quasi-anonymous, virtual currencies that have the potential to facilitate financial crime and terrorism. The OECD's Common Reporting Standard (CRS) for automatic exchange of financial account information between governments has been widely adopted. In particular, in the Asia-Pacific region, Australia, China, Hong Kong, India, Japan, Malaysia, Singapore and South Korea are performing CRS due diligence and have recently started undertaking information exchanges.

Focus on Europe

PRIIPs, MiFID2 and PSD2 took effect in January. All are intended to reflect changing markets and technology as well as improve consumer protection and choice, but it is clear already that there may be unintended effects and difficulties with implementation. MiFID2, for example, ends the practice of bundling research costs with execution services. While many investment managers have absorbed the costs of research themselves, investors may find that there is less research and fewer fund managers in future. The myriad of technical changes introduced by MiFID2 may tend to simply increase operating costs and favour fewer larger market entities.

Financial Markets

MiFIR, the MiFID2 regulation that governs trading on market venues and is a counterpart to EMIR on derivatives trading and clearing, reporting and risk mitigation, failed to reach the "starting gate" intact on day one. On its first day, national regulators in the UK and Germany granted their leading exchanges waivers exempting them from having to provide non-discriminatory access for exchange-traded derivatives (eg, futures and options) until July 2020. This is despite it being a key measure to increase competition and bring down dealing and clearing costs. Another last minute measure was the relief provided by ESMA to smooth the introduction of the legal entity identifier (LEI) requirement. Investment firms and trading venues have been allowed a temporary six-month grace period to continue providing services that would trigger the obligation to submit a transaction report without a counterparty LEI, provided they take steps to obtain the necessary documentation and apply for LEI codes for their clients.

Other concerns relate to the MiFIR share-trading obligation that requires EU investment firms to trade on an EU venue unless a third-country trading venue is considered by the European Commission to be equivalent. To date, only exchanges in the US, Hong Kong, Australia and Switzerland qualify. This rule could divert significant liquidity from non-equivalent third-country trading venues and, where these are the primary market (for any share), impact best execution. Brexit complicates matters further.

Brexit/MIFID3?

MiFID2 was conceived when London, one of the world's leading financial centres, was securely embedded within the EU. Now, we must ask how the trading obligation will work post-Brexit when the EU's principal trading venue is located in a third country. Another question concerns the new EU third-country firm access regime. When MiFID2 was drafted, it was never imagined that it might provide "equivalent" access on such a scale to UK-based financial services firms post-Brexit. With the UK's departure, there is discussion over a future MiFID3 to better suit the needs of the remaining 27 Member States. The Commission has already proposed legislation to gain greater control over the City of London's euro-clearing market.

Just before Christmas, while adopting proposals to amend EU prudential rules for investment firms, the Commission took the opportunity to say that the equivalence test should also be adjusted. It wants the requirements to be far more granular. Moreover, for third countries whose firms may be of systemic importance to the EU (Britain in the future?), any equivalence assessment would have to be very detailed with a need to show supervisory convergence with the EU – which again might pose a dilemma to the UK. More generally, MiFID2 obliges the Commission to review its operation and report to the European Council and Parliament by March 2019. It will need to start soon. If this was not enough, Brexit is not just changing rule books, but the structure of regulation itself. It is acting as a catalyst for further integration of EU Eurozone countries under the European Central Bank, and the powers and roles of the three ESAs are likely to be enhanced.

EMIR2

2018 is expected to see progress toward a proposed new regulation flowing from the planned EMIR Review (the so-called EMIR2). The proposed amendments to EMIR would make several changes in terms of reporting, clearing and risk mitigation for OTC derivatives. Many of these proposed reforms look set to reduce compliance costs for market participants, for example, the introduction of a new classification for small financial counterparties to provide them with relief from EMIR's clearing requirements. However, the EMIR2 legislation is not expected to be finalised until late in 2018, and certain aspects will be phased in, so this is still some way off in terms of application.

Payments

PSD2 promises radical change to payments. New regulated services allow payment initiation service providers to take funds directly from a customer's account, thereby disintermediating banks and card services. Similarly, customers can grant access to their account data to account information service providers. This allows aggregation of multiple accounts in one place and gives customers greater control of their data – further enhanced by the new EU General Data Protection Regulation which takes effect this May – allowing better access to and switching between financial products.

But again, implementation of PSD2 will not be smooth. In the UK, the Competition and Markets Authority has granted six banks additional time to comply with what is known locally in the UK as "Open Banking." In other Member States, the legislation is still to be implemented, for example, in Sweden and Spain. An important aspect of PSD2 is better security around authorising payment transactions and providing secure access to the new payment services. The necessary technical standards have been delayed due to politics between the Commission and the European Banking Authority, both being lobbied by banks and FinTechs regarding their competing interests. The standards are not now expected to apply until the second half of 2019, leaving unsatisfactory workarounds in the meantime.

Virtual currencies & Anti-Money Laundering

Still on the theme of payments, the European Parliament and the Council have reached political agreement over a Fifth Money Laundering Directive (5MLD), the fourth having only taken effect in Member States on 26 June 2017. 5MLD, which amends its predecessor rather than replace it, responds to concerns over virtual currencies by bringing with them within the scope of the anti-money laundering and counter-terrorist financing regimes. It catches "providers engaged in exchange services between virtual currencies and fiat currencies" and custodian wallet providers. This means that providers will have to register with the authorities, and apply systems and controls including carrying out due diligence on customers. Internationally, the authorities have struggled with and taken different approaches as to what constitutes a virtual currency. The definition chosen in 5MLD is broad, being "a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons, as a means of exchange, and which can be transferred, stored and traded electronically." Perhaps more straight forward, a custodian wallet provider is "an entity that provides services to safeguard private cryptographic keys on behalf of their customers, to hold, store and transfer virtual currencies."

Despite these steps, it is recognised that bringing these providers into the AML-regulated community will not entirely resolve the risks posed by the anonymity of such currencies, because users can and do transact without them. The provisions will not apply across the EU until late 2019, although the UK, if not distracted by Brexit, may act earlier. When it is was first proposed that virtual currencies be brought within anti-money laundering regulation, there was opposition on the basis that regulation might be misinterpreted as a stamp of regulatory approval on the whole concept. As Bitcoin has shown (although perhaps it is an extreme example), such currencies can be unstable and fail to provide a secure and stable means of storing and transferring value. Will they now be given an additional fillip if they need one to increase their popularity?

Enforcement

Overall, 2017 was a quieter year for UK enforcement in terms of published cases. The FCA imposed 13 fines in 2017 compared to 23 fines in 2016 and 40 in 2015. While we are not likely to see the same volume of cases as in 2016 and 2015, the likelihood is that 2018 will be a busier year.

The first cases under the Senior Managers Regime will start to emerge, reinforcing the trend that has seen a 75% increase in investigations into individuals. With the planned expansion of the regime, individual responsibility will be a key theme. Another source of cases will be MiFID2. The FCA will be paying close attention to implementation and bedding in of new rules. Enforcement is a risk for firms who are considered non-compliant.

New EU legislation includes compulsory minimum enforcement powers for national regulators. Will we begin to see more enforcement in other parts of the EU or perhaps from the ESAs and the ECB given their expanded roles?

Focus on Asia-Pacific

Financial services firms in 2018 will continue to face the challenges of navigating highly heterogeneous financial markets while operating within an increasingly interconnected global economy. As Asian countries continue to develop at different stages of economic growth, their institutional requirements and regulatory objectives have diverged accordingly, posing unique challenges to policymakers. Not least of these is the extent to which the region's financial markets can, and should, converge on international standards and rules arising from global regulatory reform. Despite regulatory fragmentation, some common themes are emerging across the Asia-Pacific region – discussed below – which we expect will dominate the outlook for financial services firms in the forthcoming year.

Impact of MiFID2

Just as US firms are experiencing, the EU's MiFID II is expected to affect Asian asset managers and brokers as well as European fund houses' Asian businesses. An Asian firm sending orders to an EU-based investment firm (including its EU subsidiary based in a third country) will need to provide its LEI code or that of its clients prior to any transaction. Many Asian markets have their own system of identification and this may only complicate matters.

Again, as referred to above, the trading obligation introduced by MiFIR seeks to return liquidity to trading venues and improve price discovery. As a general rule, EU-based investment firms cannot execute a trade in shares admitted to trading on an EU regulated market (or other EU trading venue) unless it takes place on such a venue, a "Systematic Internaliser" or an equivalent third-country trading venue. If trading is to take place on a third-country trading venue because it is the primary market, an EU-based investment firm may only do so if the Commission deems it "equivalent" to an EU venue. Such assessments over equivalence can be a lengthy process. Therefore, notwithstanding any conflicts over best execution, Asia-Pacific markets potentially face a loss of order flow and liquidity to EU venues. To date, only Hong Kong qualifies.

FinTech

Asian governments and market regulators have been quick to recognise the opportunities for tech-driven innovation, and continue to invest heavily in policies and programmes to promote and facilitate new entrants and technologies. In an effort to become Asia's FinTech hub, several Asian economies, including Singapore, Hong Kong, Indonesia, Malaysia and Thailand, have followed the UK's lead by introducing regulatory sandboxes for businesses to test innovative products and delivery mechanisms within a "safe" environment.

The primary and motivating concern underpinning these initiatives is the need to protect consumers and maintain financial system stability. We are already seeing how this ongoing challenge is starting to shape each country's supervisory and regulatory approach toward evolving innovation. Cryptocurrencies and ICOs, for example, will continue to feature prominently on the regulatory agenda, with the more active Asian ICO market regulators already taking strikingly divergent positions. China's digital transformation in the non-banking payments space has made it a leading force in the global digital economy, and has spurred the central bank to introduce large-scale measures to give it greater visibility and control over China's vast third-party payments oligopoly. As a necessary corollary to creating a supportive FinTech environment, several Asian market regulators are formulating cybersecurity policies to mitigate data and cyber risks. Work will continue this year to implement robust frameworks to improve cyber and operational resilience.

Virtual currencies

The explosive rise of ICOs as a new form of capital raising has regulators in the region adopting diverse and sometimes polarised positions. Australia, Hong Kong, Singapore and Malaysia have made it clear they do not currently regulate digital currencies, but have indicated that the way in which an ICO is structured and the nature of the rights attaching to the coins will determine whether it is likely to be regulated as a security and subject to disclosure and other laws. Japan, on the other hand, has introduced a definition of regulated virtual currencies, as well as a licensing system for virtual currency exchange businesses. To date, Japan's Financial Services Agency has issued 16 licences to virtual currency exchanges to allow them to operate legally. While there are no specific regulations for ICOs, the regulator has made it clear they may be subject to existing laws and regulations depending on their structure.

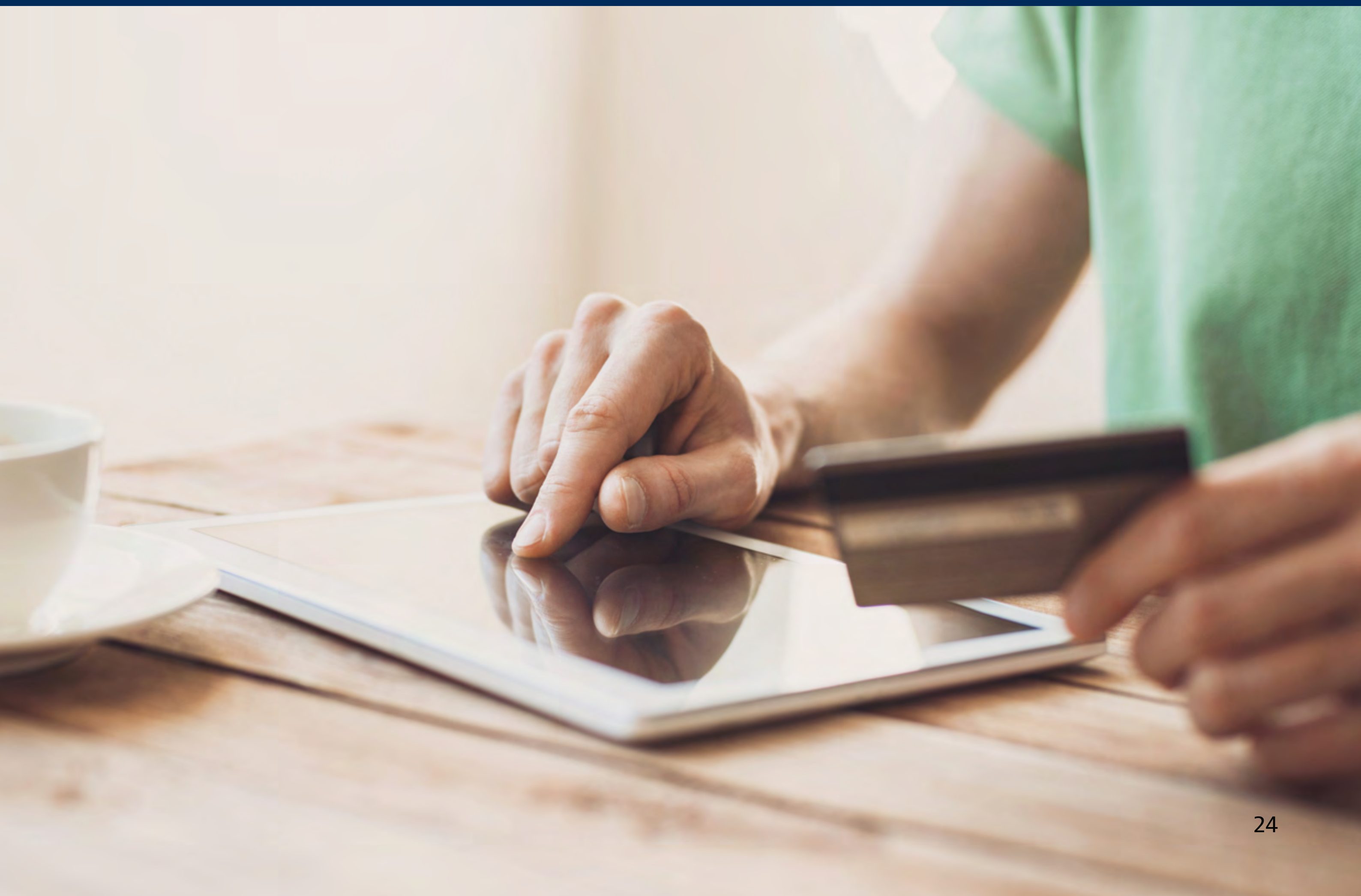
Chinese and Korean regulators, in stark contrast, banned all fundraising activities involving cryptocurrencies last year, with China also recently blocking banking services for cryptocurrency trading. The People's Bank of China (PBoC) went a step further to order the closure of all domestic digital currency exchanges, with Korea's Financial Services Commission (FSC) last year threatening to do the same. The FSC has recently softened its stance, possibly in response to decreased speculation in cryptocurrency trading, and clarified that an outright ban is only one of the steps being considered. There are already indications that additional regulation may be introduced in 2018 to manage crypto trading risks, including the adoption of a cryptocurrency exchange approval system. With China taking out the world's biggest market for token sales, ICO activity in the rest of the region has increased significantly. It is perhaps still too early to tell which of the economies will emerge as Asia's ICO hub, but Singapore's Monetary Authority's (or MAS) much-lauded transparent framework and open dialogue with the crypto community potentially places Singapore in the lead for 2018 and beyond. In other regions, the regulatory response is just as confused. The UK's FCA takes a nuanced approached looking at the regulatory status of ICOs on a case-by-case basis, while warning consumers that they are high-risk speculative investments.

Payments

Globally, the enthusiasm for innovation has been tempered by policymakers' need to comprehend and mitigate the potential risks to consumers and the soundness of the financial system. China's powerhouses, Baidu, Alibaba and Tencent, have had a profound impact on the way business is done there, collectively creating a digital ecosystem that has made China the largest mobile payments and e-commerce market in the world. The sheer scale of the country's non-banking payments sector has prompted the PBoC to require all mobile payments to be cleared through a centralised clearing house by June this year, in order to provide greater transparency over the third-party payments market and to enable the central bank to more easily detect money laundering and other illicit activities.

Singapore's MAS is also moving forward with a new Payment Services Bill which will overhaul the current regulatory framework in the payments space. The changes will bring previously unregulated activities such as virtual currency intermediation and inward remittance under regulatory purview, giving the MAS greater oversight into money laundering and other risks.

Following the UK's Open Banking and the EU's PDS2 initiatives, the development of open banking infrastructure is gaining traction in Asia-Pacific, driven by a shared goal to increase competitiveness in the retail banking and payments sectors and reform the way in which banking services are delivered. Several countries, including Singapore, Japan and more recently Hong Kong and Malaysia, are formulating frameworks and guidance to facilitate the adoption of Open Application Programming Interfaces (API), which we expect will continue to evolve over the coming year.



Anti-Money Laundering

Anti-money laundering will continue to be a tremendous regulatory challenge for Asia-Pacific financial institutions. Regulators in the region are working toward harmonising local AML/CTF frameworks with FATF recommendations and have signalled their commitment to taking a more aggressive enforcement approach toward money laundering, terrorist financing and weapons proliferation. Singapore, Hong Kong and Australia are leading the region in combating money laundering activities, and the regulators' resolve in those countries to step up scrutiny and impose tougher sanctions shows no signs of abating in 2018.

In the wake of the 1MDB scandal, which saw the MAS close down two banks, impose fines totalling an equivalent of USD 22 million against eight others and launch a dedicated AML enforcement unit, Singapore financial institutions and their senior management can expect swift and targeted enforcement action for AML contraventions. The Hong Kong government is busy preparing for a critical mutual evaluation by the FATF later this year, including amending its AML/CTF legislation to improve corporate transparency and extend statutory AML requirements to designated non-financial businesses and professions. The Hong Kong Monetary Authority (HKMA) and AUSTRAC have identified trade-based money laundering activities as a particular risk in the region and are expected to intensify their scrutiny in this area. Australia has commenced implementing its second tranche of amendments to its AML/CTF legislation, which is estimated to enter force in 2019.

Conduct, Culture and Accountability

The increasing number of incidents of corporate misfeasance and market misconduct in the region has resulted in greater oversight, with regulators moving away from a reactive to a pre-emptive and front-loaded approach to supervision. We expect to see a greater focus on investor protection, particularly in relation to mis-selling practices and compliance with suitability obligations, which, in some cases such as Australia, will soon be supported by enhanced regulatory powers of intervention in the product distribution process. Across the region, regulators are striving to improve governance practices and raise awareness of management accountability in an effort to transform firm culture and conduct, a trend that will continue in 2018.

Exposing corporate fraud and misfeasance remains one of the highest enforcement priorities for Asia-Pacific regulators. Last year, China announced it would establish a cabinet-level committee to coordinate financial oversight while also significantly increasing supervisory and enforcement efforts. Heavy penalties were imposed against banks and insurance and securities companies for misfeasance, market misconduct and other irregularities, including a recent fine by the China Banking Regulatory Commission of around USD 72 million on a bank branch relating to extensive shell company fraud. Australia has recently established a Royal Commission into the alleged misconduct in Australia's banking, superannuation, insurance and financial services industries, which will consider, among other things, the culture and governance practices of financial services entities.

Mis-selling continues to be one of the most common types of misconduct across Asia-Pacific, particularly in the wealth and insurance industries where complex products are frequently marketed. Last year in Hong Kong, a private-banking unit was fined a record USD 51 million over sales of structured products linked to Lehman Brothers, the largest fine ever issued by the Hong Kong regulators. The Australian government is also set to introduce important reforms to safeguard consumers against inappropriate selling practices by financial product providers. Among other things, the proposed Product Intervention Power will empower the Australian Securities and Investments Commission to intervene in the distribution of a product where it perceives there to be a risk of significant consumer harm. This follows the introduction of such powers in the EU under the MiFID2 and PRIIPS legislation.

Underpinning these measures is the perception that firm culture and conduct are the key drivers to ensuring ethical behaviour toward customers. We expect to see a far greater focus by regulators across the region on shifting firm culture toward a more customer-based model, directed by the "tone from the top." The need to identify who has overall responsibility for what and holding them accountable for the firm's conduct and behaviour has been the guiding principle underlying Hong Kong's Manager-in-Charge regime (which became fully operational in October 2017) and the more recent HKMA's Management Accountability at Registered Institutions requirements. In Australia, the federal government's Banking Executive Accountability Regime (BEAR), which is expected to take effect on 1 July 2018, aims to reform the accountability framework of authorised deposit-taking institutions and tighten the obligations of those in senior executive positions. The regime will be complemented by enhanced powers of investigation of the Australian Prudential Regulation Authority. All this is reflected in the UK's Senior Manager's regime, which is due to be extended from banks to insurers in late 2018 and to most financial services businesses in 2019.

Focus on United States

In the US, it is likely that the deregulation of the financial sector that has begun under the Trump administration will continue and may, in fact, gather steam.

In February 2017, President Trump issued an Executive Order, "Core Principles for Regulating the United States Financial System," which sets forth goals to "make regulation efficient, effective, and appropriately tailored" and to "restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework." The core principles also stressed enhancing economic growth and the competiveness of American companies globally. In addition, the core principles directed federal agencies to identify current laws, requirements and other policies that inhibit federal regulation of the US financial system in a manner consistent with the core principles.

In response to this order, the US Treasury has issued three (out of an expected four) reports containing recommendations on how to improve the efficiency of financial sector regulation. These reports set out an ambitious and comprehensive plan to revise financial services regulation in the US. Many of the proposals will require legislative action, but there are many others that can be implemented by administrative action.

Many of the people appointed by President Trump to head federal agencies regulating the financial sector are considered to support a deregulatory agenda, such as Jerome Powell, the chair of the Board of Governors of the Federal Reserve System, J. Christopher Giancarlo, the head of the CFTC, and Jay Clayton, formerly of Sullivan and Cromwell, who now heads the SEC.

While deregulation may be coming with respect to many areas of US financial services, we expect that regulation in certain areas, such as cryptocurrencies, ICOs and AML compliance, to increase substantially, as the CFTC and SEC become more knowledgeable about such products.

The core principles and the Treasury have indicated that a part of the contemplated deregulatory focus will be a review of the impact of international financial standards on the competitiveness of US financial institutions. The Treasury has indicated that it generally supports efforts to finalise the remaining elements of international financial reforms at the Basel Committee, but that it recommends that the US attempt to narrow the scope of the initiatives of international standard-setting bodies, specifically by streamlining their mandates and eliminating existing overlapping objectives. In addition, the Treasury has recommended increased transparency and accountability at the international level. It has also recommended that the US continue to argue for international regulatory standards that are in alignment with US domestic financial regulatory objectives and for the possible recalibration of US implementation of certain international financial regulatory standards.

Leveraged Lending Guidelines

The Treasury report addressing banks and credit unions, which was issued in June 2017, identified concerns that the inter-agency leveraged lending guidelines issued in 2013 were ambiguous as to the leveraged lending covered by the guidelines and lacked clarity on the penalties to be imposed for violation. The Treasury also noted that, although there had been a reduction in leveraged lending by banks, this had not led to a reduction in risk in the financial system, due to less-regulated non-bank lenders having increased their leveraged lending exposure. The Treasury recommended reissuing the guidelines for public comment and refining them to reduce ambiguity and achieve consistency in supervision, examination and enforcement.

In October 2017, the US Governmental Accountability Office issued an opinion that the guidelines were a "rule" covered by the Congressional Review Act (CRA); this raises the possibility that, under the CRA, these guidelines could be disapproved of by Congress by simple majorities in each of the House and Senate. In addition, if Congress disapproves a rule under the CRA, the rule cannot be administratively adopted again in a similar form.

Changes at the Consumer Financial Protection Bureau (CFPB)

The Treasury report addressing banks and credit unions recommended that extensive reforms be made to the CFPB. The Treasury expressed the view that the structure and unduly broad regulatory powers of the CFPB had led to regulatory abuses and excesses that had decreased the accessibility of credit for consumers.

Recently, Richard Cordray, who had been appointed by former President Obama as the first head of the CFPB, resigned. Prior to resigning, he purported to appoint his own successor, Leandra English. President Trump also appointed a successor, Mick Mulvaney. Ms. English has sued. A federal court refused to grant Ms. English the preliminary injunction she had sought. The litigation continues.

Using the CRA, in November 2017 Congress disapproved the CFPB's "arbitration rule." This would have prohibited firms providing certain consumer financial products and services from requiring customers to arbitrate disputes so to prevent them from filing or participating in a class-action lawsuit. In October 2017, the CFPB issued a rule governing "payday loans, vehicle title loans, and certain high-cost instalment loans." Legislation has been introduced under the CRA to disapprove this rule as well.

Possible Dodd-Frank Legislative Rollback

In the Treasury report addressing banks and credit unions, it recommended significant changes to the Volcker rule (which prohibits proprietary trading and holding covered funds), including (i) exempting banks with USD 10 billion or less in assets from the rule, and (ii) modifying the covered funds provisions of the rule to decrease unnecessary burden. Subsequently, in August 2017, the Office of the Comptroller of the Currency consulted on revising the Volcker rule. The comment period expired in September 2017, and several institutions and industry groups provided feedback. Many comments stressed that the implementing regulations for the Volcker rule were too complicated and went beyond what Dodd-Frank required. Any change to the Volcker rule would have to be agreed upon by multiple regulatory agencies.

In December 2017, the Senate Banking Committee approved a bipartisan bill that would deregulate some of the Dodd-Frank rules. Among other things, the bill would exempt banks holding assets of USD 10 billion or less from the Volcker rule and increase the asset threshold for determining if a bank is a systemically important financial institution (SIFI) from USD 50 billion to USD 250 billion. It will now be considered by the full Senate.

The House of Representatives had passed a more ambitious Dodd-Frank rollback bill, known as the Financial CHOICE Act, in June 2017. Unlike the House bill, the Senate bill would preserve much of the CFPB, although in a restructured form.

Risk Retention

In the Treasury report addressing capital markets, there were several recommendations concerning the Dodd-Frank risk retention requirements for securitisations, including that (i) federal banking regulators expand qualifying risk retention exemptions, (ii) regulators review the mandatory five-year holding period for third-party purchasers and sponsors and (iii) a broad qualified exemption for CLO risk retention be implemented. It remains to be seen whether any of these recommendations will be brought to fruition.

We note that the Loan Syndications and Trading Association (or LSTA) had sued the SEC and the Federal Reserve over the risk retention rule. The case was originally dismissed by the US District Court for the District of Columbia. In late 2017, the case was argued on appeal to an appellate court.

Meanwhile, the EU has strengthened its retention requirements in a new Securitisation Regulation which takes effect from 1 January 2019. However, the minimum retention figure of 5% of the loan portfolio first adopted in 2011 through the Capital Requirements Regulation remains at the same level.

Derivatives

In the Treasury report addressing capital markets, among other things, the Treasury recommended (i) greater regulatory coordination and harmonisation between the SEC and the CFTC, (ii) that the CFTC maintain the swap dealer de minimis registration threshold at USD 8 billion (rather than having it reduced to USD 3 billion, as it is scheduled to do) and (iii) that regulators properly balance the post-crisis goal of moving more derivatives into central clearing with appropriately tailored and targeted capital requirements. In addition, the Treasury also recommended that the CFTC and the SEC make their swaps and security-based swaps rules compatible with those of non-US jurisdictions and clarify the scope of their jurisdiction over non-US swaps.

Moreover, progress has been made as regards recognition of US derivatives regulations by other jurisdictions. In October 2017, the EU recognised the legal, supervisory and enforcement arrangements of the US with respect to derivatives transactions supervised by the CFTC as equivalent to certain requirements of EMIR. This means that, where at least one of the counterparties is established in the US, some of its EMIR obligations (including clearing, reporting and risk mitigation) related to the CFTC regulated derivative transaction will be deemed to have been fulfilled by complying with the US requirements. Such developments can only help to ensure a more internationally consistent application of derivatives regulation.

As noted above, the CFTC and SEC have become active in regulating cryptocurrencies and ICOs, and we expect such regulation to increase. The CFTC considers Bitcoin and other cryptocurrencies to be commodities. As a result, derivatives contracts based on a cryptocurrencies and certain retail leveraged spot contracts are subject to its jurisdiction.

The SEC has also been aggressive in taking enforcement action against ICO issuers, such as The DAO and several others, while refusing to approve ETFs based on cryptocurrencies. Indeed, with respect to ICOs, in December 2017 and at various times thereafter, SEC chair Jay Clayton has stated that the SEC will police ICOs vigorously and will continue to examine the role of cryptocurrencies. Mr. Clayton indicated that products linked to the value of underlying digital assets, including Bitcoin and other cryptocurrencies, may be structured as securities products subject to regulation under the Securities Act of 1933 or the Investment Company Act of 1940.

Other U.S. regulators are also actively involved in considering—or implementing—regulation for cryptocurrencies, including FINRA, the Financial Stability Oversight Council, FinCEN, and the Consumer Financial Protection Bureau—as well as Congress, which has recently held hearings on the subject.

At the state level, the National Conference of Commissioners on Uniform State Laws has drafted a proposed uniform state law, the Uniform Regulation of Virtual Currency Businesses Act. This would require licensing of, and impose prudential regulations and customer protection requirements on, businesses engaged in virtual currency business transactions. Many of these businesses are already regulated by money transmitter statutes in certain states, and a properly tailored uniform statute, if adopted by many states, could have the benefit of making compliance more efficient. It remains to be seen how this initiative will be received by the market and by state legislators.

Anti-Money Laundering

In 2018, two new major regulatory requirements will take effect (1) the Financial Crimes Enforcement Network's (FinCEN) Customer Due Diligence/Beneficial Ownership Rule and (2) the annual certification component of Rule 504 of the New York State Banking Regulations.

The FinCEN rule was promulgated under the Bank Secrecy Act (BSA) in 2016 with an effective date of 11 May 2018. The rule will require financial institutions to identify and verify the identity of the beneficial owners of all legal entity customers (other than those that are excluded) at the time a new account is opened (other than accounts that are exempted). A financial institution may comply either by obtaining the required information on a standard certification form or by any other means that comply with the substantive requirements of this obligation. It may rely on the beneficial ownership information supplied by the customer, so long as it has no knowledge of facts that would reasonably call into question the reliability of the information.

Under Rule 504, all financial institutions regulated by the New York State Department of Financial Services (DFS) are currently required to adopt and maintain a transaction monitoring and filtering program with respect to BSA/AML violations and suspicious activity reporting. Commencing on 15 April 2018, regulated institutions will be required to make an annual finding on whether the institution is in compliance (ie, a board resolution or by a senior officer) and submit this to the DFS.

In the US, we expect that financial services regulation will continue to be a fertile area for development in 2018. While much may depend on the outcome of the midterm elections later in the year, it is clear that many federal regulators are taking a look at much of the regulation enacted during the Obama years with a view toward revising it, perhaps extensively, to make it work better, and to undo unnecessary or excessive regulation. This deregulatory push may also manifest itself in US efforts to recalibrate international standards.

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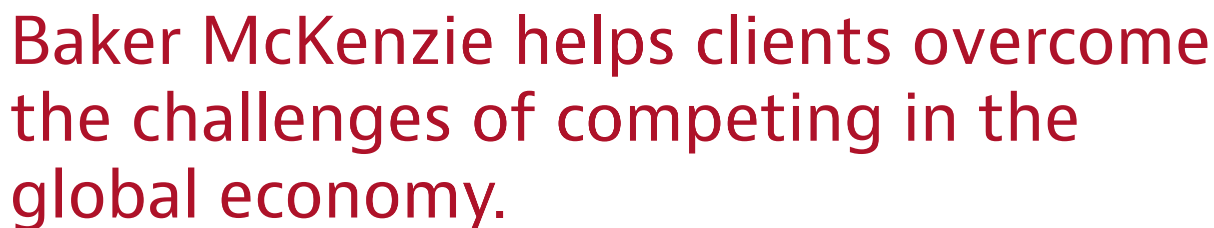

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