



TRANSFORMATION IS INEVITABLE – KEY THEMES FOR ASSET MANAGERS IN 2023 AND BEYOND

Welcome to the latest article in our ‘Transformation is Inevitable’ series, where we provide insights based on our on-going analysis of the complex, changing and ambitious regulatory policy environment, evolving customer needs, as well as advancing technology.

In earlier articles we looked at the future of work and sustainable finance, the potential risks arising from the increasing use of cloud outsourcing and how regulators adjusted their agendas to tackle the impact of COVID-19 on financial services, amongst others.

In this article, we consider the key regulatory themes to watch out for in 2023 and beyond. Certain themes will be familiar, whilst others may only just be entering the peripheral scope for the asset management industry.

UK/EU Divergence

Post-Brexit, the Retained EU Law Bill will automatically revoke most retained EU law at the end of 2023, as part of a ‘sunset clause’.¹

This will not apply to retained EU law that was already domestic primary legislation and any retained EU law that still applied after the end of 2023.

From an EU perspective, a recent study commissioned by the ECON Committee of the European Parliament looked at factors affecting regulatory equivalence between the UK and EU.²

The study found that divergence is “almost a given outcome” but that several factors could still influence how wide the gap would become. Politics being a key one. The study then went on to say that it expects that divergence will increase over the coming years, especially in areas where no inherited regulatory framework exists. For example, in areas such as fintech, crypto assets and green finance.

What has the UK approach been to date?

In terms of the UK’s process in unravelling EU legislation, the Financial Services and Markets Bill (FSM Bill),³ and the UK Government’s announcement of the Edinburgh Reforms⁴ are currently working their way through the legislative process.

The draft legislation that will enable the implementation of the outcomes of the Future Regulatory Framework Review is in the FSM Bill, so once it finally becomes law, the regulatory framework will change.⁵

Of direct relevance to asset managers, the UK Financial Conduct Authority (FCA) has recently published a Discussion Paper entitled ‘Updating and improving the UK regime for asset management’ (DP23/2).⁶

This may be described as the UK regulator doing some blue sky thinking in terms of what the UK regulatory regime could become. Nothing concrete at this stage, but the discussion paper represents the beginning of what will be a longer interactive dialogue over the next few years.

FCA supervisory focus for 2023

One document that does clearly set out the FCA's supervisory focus areas for the asset management industry in 2023 is its most recent Dear CEO Letter.⁷ The letter was informed by the FCA's latest risk assessment and is based on information taken from its supervisory work, firm and fund authorisations, external data, and interactions with asset managers and global regulators.

The overall theme identified by the FCA is governance, because it has evidenced that ineffective governance is "a root cause

*of some Asset Managers failing to mitigate material risks or progress towards better outcomes for their customers."*⁸

As a result, the FCA says that it is essential that Senior Managers and governing bodies consider whether the risks of harm outlined in its Dear CEO Letter are present in their firms, adopt strategies for mitigating them, and are able to demonstrate to the FCA that they have taken these steps. The FCA says that firms and Senior Managers that fail to do this risk finding themselves under scrutiny by it.

THE FCA'S 5 PRIORITIES FOR 2023



Product Governance

In keeping with other FCA initiatives, including the Asset Management Market Study,⁹ the Assessment of Value¹⁰ (AoV), and most recently the new Consumer Duty,¹¹ The combined effect of which the FCA has intended to be a shift in how firms across the financial services sector service their customers. In relation to the AoV, the FCA states it will follow up on its 2021 AoV review findings and seek to identify outlier firms. The FCA will also consider in its upcoming review how firms have built maturity of ESG in value assessment considerations.



ESG and Sustainable Investing

Sustainability remains an area of focus, in particular, given the recent FCA consultation CP22/20.¹² The CP, amongst other things, proposes a new anti-greenwashing rule which will apply to UK regulated firms.

Overall, the FCA is looking to ensure that governance bodies are appropriately structured to oversee and review management information about product development, ESG and sustainability integration in investment processes, third-party and proprietary ESG information providers, and other ESG and sustainability claims made by firms.



Product Liquidity Management

The FCA says this topic is particularly pertinent when markets are volatile, making liquidity risks relevant across products. In terms of actionable steps, the FCA asks firms to review their liquidity management tools and strategies to ensure they are:

- Fit for purpose;
- Can be executed at pace; and
- Can be scaled to handle additional demand when needed.

Going forward, the FCA will be conducting a multi-firm liquidity management review and will continue to work with the Bank of England and international regulators on elements of the financial system that have shown the most liquidity vulnerability, such as money market funds, with a view to strengthening resilience.



Investment in Operations and Resilience

The FCA wants firms to invest more in operations and resilience and to be able to respond to challenges in a timely manner. The FCA also focuses on firms' use of third-party arrangements and stresses that, if third parties (whether external or intra-group) are essential to operational resilience, that the regulated firm should ensure that such third parties are able to continually deliver the services required to allow the firm to meet its regulatory obligations.

Asset managers are also reminded of the requirement to have set impact tolerances following the 2021 FCA policy statement PS21/3 'Building operational resilience' and to remain within them by 31 March 2025.¹³

The FCA will be launching a range of proactive programmes to monitor and test asset managers' ability to meet these regulatory requirements and may select specific firms for further review.



Financial Resilience

This ties in with the FCA's work on the Investment Firms Prudential Regime (IFPR)¹⁴ and increased monitoring of asset managers' prudential health.

On 27 February 2023, the FCA published initial observations on firms' implementation of the IFPR requirements.¹⁵ The FCA recommends that firms consider these observations and assess their processes accordingly, to determine whether there is any need for strengthening them.

Another focus referenced by the FCA, under the umbrella of financial resilience, is client money. The FCA continues to stress the importance of compliance with CASS to ensure that client money is both protected and capable of being transferred promptly, if a firm fails.



Broader regulatory focus areas (EU and UK)

In terms of the broader regulatory areas that both EU and UK regulators continue to focus on, these cover areas such as disclosures, inducements, long-term investing, and senior accountability. There is also focus by both the UK and EU regulators on certain regulations. In the UK, this is part of the FSM Bill and the Edinburgh Reform package. Whilst in the EU, the furtherance of the Capital Markets Union action plan.¹⁶

Crypto assets and CBDC

One of the most significant regulatory and legal quandaries associated with crypto assets is the need for definitional clarity. The emergence of entirely new types of assets, which sometimes resemble traditional assets like securities, commodities, or currencies, has created a need for new statutory definitions to provide regulatory certainty for the sector.

While regulators are taking a progressive approach to crypto assets, the current regulatory picture remains fragmented at a global level with a wide range of approaches and unfolding initiatives.

In the United States, regulators such as the Securities and Exchange Commission (SEC) has pursued enforcement actions, rather than proposing rules. Whilst in Hong Kong the regulators allow asset managers and exchange-traded fund providers to launch retail ETFs with virtual asset futures as underlying assets.

The G20 has tasked the Financial Stability Board (FSB) with coordinating the delivery of an effective and comprehensive regulatory framework for crypto assets.¹⁷

During 2023 the FSB will finalise its recommendations for the regulation, supervision and oversight of crypto assets and markets and its recommendations targeted at global stablecoin arrangements. Then, later in 2023, the FSB will issue a paper jointly with the International Monetary Fund (IMF) that synthesises the policy findings from the IMF work on macroeconomic and monetary issues.

Technology agnostic approach

Attempts to apply traditional laws and regulations to crypto assets can be likened to fitting the proverbial square peg into a round hole. The lack of definitional clarity also raises

jurisdictional questions about which regulator should regulate which digital assets.

In the UK, HM Treasury (HMT) recently published a consultation paper¹⁸ saying that maintaining financial stability and clear regulatory standards are key to its proposals, with the UK government's starting point being that the technology must fit existing regulations where possible and only in limited examples will the Regulatory Activities Order (RAO), the basis of financial regulation in the UK, or the Financial Services and Markets Act (FSMA), be amended.

So in other words, if it looks like a share and acts like a share, it should be treated like a share regardless of the technology involved.

CBDC to be dealt with separately

In February 2023, the Bank of England (BoE) and HMT published a consultation paper on a potential digital pound.¹⁹

The digital pound will be the UK's Central Bank Digital Currency (CBDC), a fiat-backed stablecoin tied to sterling and issued by the BoE.

The BoE and HMT state that, while at this stage they judge it likely that the digital pound will be needed in the future, it is too early to decide whether to introduce the digital pound. However they are convinced preparatory work is justified.

Other jurisdictions around the world are also looking at the feasibility of issuing CBDCs with the US, European Central Bank, and China (amongst others) in various stages of implementation.

Regulation in the pipeline

The EU Markets in Crypto Assets (MiCA) creates a broad regulatory framework for crypto assets in the EU and is nearing completion. It will:



Regulate the issuance of, and admission to trading of, crypto assets, including transparency and disclosure requirements;



Introduce licencing of crypto asset service providers, issuers of asset-referenced tokens and issuers of electronic money tokens;



Clarify the regulatory obligations applicable to issuers of asset-referenced tokens, issuers of electronic money tokens and crypto asset service providers, including consumer protection rules for the issuance, trading, exchange and custody of crypto assets;



Strengthen confidence in crypto asset markets by creating a market abuse regime prohibiting market manipulation and insider dealing; and



Clarify the powers, including the co-operation and sanctions framework, available to competent authorities.

The European Parliament formally endorsed the regulation on 20 April 2023.

Whilst in the UK, in February 2023, HMT published proposals to regulate crypto assets and protect consumers. Under the proposals the UK government will set out what it refers to as:

- Ambitious plans to robustly regulate crypto asset activities - providing confidence and clarity to consumers and businesses alike;
- Looking to strengthen rules for crypto trading platforms and a robust world-first regime for crypto lending; and
- Deliver on its financial services roadmap by embracing technological change and innovation, delivering on the Prime Minister's plan to grow the UK economy.

The House of Commons Library also published a research briefing on cryptocurrencies,²⁰ which considers: the definition of cryptocurrencies; how they work; the benefits and challenges that they offer; and political and regulatory responses.

Watching crypto brief for asset managers

Due to its ongoing evolution internationally, the regulation of crypto assets is something that may be of interest to asset managers, but as a peripheral theme. In the recent FCA Discussion Paper it considers a potential future for the asset management regime,²¹ where the FCA is specifically considering modernisation of the way in which fund units

are bought and sold (D2F²²), fund tokenisation and investing in crypto assets.

Operational resilience with a focus on ICT risks

Operational resilience remains one of the top supervisory priorities for regulators around the world.

Regulators have increasingly become more aware of how firms in the financial services sector have become so dependent on technology and how any disruption to this technology could have serious repercussions from an operational resilience perspective.

In October 2022, the FSB published a consultation on 'Achieving Greater Convergence in Cyber Incident Reporting',²³ recognising that timely and accurate information on cyber incidents is crucial for effective incident response and recovery and promoting financial stability and with a view to ensuring that financial institutions operating across borders are not subject to multiple conflicting regimes.

An IOSCO report on operational resilience published back in July 2022²⁴ noted that the existing IOSCO operational resilience principles, recommendations and guidance provide the core structure for regulated entities and regulators when considering operational resilience, and the findings in the report suggest this framework had worked well during the COVID pandemic. Despite this though, IOSCO did identify some areas of learning to help inform future operational resilience arrangements.

In the UK, new rules and guidance on operational resilience came into force on 31 March 2022. Firms within scope of the new rules have to perform mapping and testing by 31 March 2025.

The UK's Prudential Regulation Authority has, so far, given soft guidance in the form of speeches setting out where it expects firms to focus on as they work towards the 2025 deadline.

Further reforms in this area are on the horizon with the UK financial services authorities issuing a Discussion Paper on critical third parties. DP22/3: Operational resilience: critical third parties to the UK financial sector.²⁵



Focus on ICT

One to spotlight though is Europe's approach. The European Commission (EC) has focused on Information and Communications Technology (ICT) in the form of a European Act covering operational resilience.

The EC deemed it would be best to incorporate operational resilience into one Act, to create a level playing field for all EU member states.

The Digital Operational Resilience Act (DORA)²⁶ seeks to establish a harmonised digital operational resilience standard applicable to the EU financial sector and requires 'financial entities,' including EU investment firms and EU managers of alternative investment funds (AIFMs) to (among other things):

- Have in place a comprehensive ICT risk management framework that ensures an effective and prudent management of all ICT risks; and
- To manage ICT-related risks and disruptions.

DORA acknowledges that ICT incidents and a lack of operational resilience have the possibility to jeopardise the soundness of the entire financial system, even if there is "adequate" capital for the traditional risk categories.

DORA will apply from 17 January 2025.

In the interim we will see the implementing and technical standards required to support the primary legislation. Technical details will need to be produced in a fairly short timeframe.

ESG and sustainable investing

This continues as a global theme, with the US and UK proposed regulations being the latest to emerge.

In 2022, the SEC advanced several ESG proposals covering:

- Corporate board diversity;²⁷
- Climate-change disclosures;²⁸
- A recommendation for it to consider rule amendments to enhance registrant disclosures regarding human capital management;²⁹ and

- Disclosures by investment companies and investment advisers related to ESG investment claims and factors which includes additional disclosures in fund prospectuses, annual reports and adviser brochures.³⁰

Disclosure - internationally interoperable and more readily available

Over the last couple of years, asset managers have responded to regulations such as the EU SFDR³¹ and have been sourcing the associated data to assist with their own disclosure obligations.

The International Sustainability Standards Board (ISSB) has recently agreed the framework for a global baseline of sustainability disclosures, which are intended to meet the information needs of global investors.³²

These standards, under IFRS S1, which covers general requirements, consistent with TCFD requirements and IFRS S2, covering climate, are intended to enable companies to provide comprehensive sustainability information to global capital markets.

The ISSB's aim is for its framework to become the building blocks of disclosure, which are jurisdiction-specific and aimed at broader stakeholder groups and can be added to the global baseline of jurisdiction-specific sustainability disclosure.

The standards are expected to be issued toward the end of quarter 2 in 2023 and to be effective from January 2024.

In addition to this, new EU rules are intended to further standardise the reporting of social and environmental information. The Corporate Sustainability Reporting Directive (CSRD)³³ entered into force on 5 January 2023 and will apply in four stages - starting from 2025 up to 2029:

- Companies already subject to NFRD **reporting in 2025** on financial year 2024.
- Large companies currently not subject to the NFRD **reporting in 2026** on financial year 2025.
- Certain listed SME's (i.e. excluding micro undertakings) **reporting in 2027** on financial year 2026.



- Companies listed in EU regulated markets, companies with subsidiaries in the EU and companies outside of the EU (or non-EU) with more than 150 million Euro turnover at the group level **reporting in 2029** on financial year 2028.

The EC is also going to bring forward delegated acts in 2023, covering the technical specifications which will support the CSRD.

Disclosure - potential risks in the spotlight

Regulators globally have been vocal in expressing their concerns regarding the potential for greenwashing.

Litigation risk has also given rise to a new trend named by some as 'green hushing,' whereby companies may refrain from disclosing details of their sustainability goals and practices for fear of being penalised for the information disclosed.³⁴



FUTURE SUSTAINABILITY POLICIES

In the UK, in October 2022, the FCA published CP22/20 **Sustainability Disclosure Requirements (SDR) and investment labels**.³⁵ This contains, amongst other things, a new anti-greenwashing rule which applies to UK regulated firms and requires firms to ensure that any reference to the sustainability characteristics of a product or service is consistent with the sustainability profile of the product or service, and is clear, fair and not misleading.

The FCA is aiming to publish its **final Policy Statement on its Consultation Paper on SDRs and labels during the third quarter of 2023**.

The European Supervisory Authorities (ESA's) Call for Evidence³⁶ also sought input on potential risks arising from misleading disclosure practices in the whole EU financial sector, including asset management. A progress report is anticipated by the end of May 2023, with the final report expected by end of May 2024.

Increasing focus on human rights impacts in supply chains

Geopolitical conflicts, inflation and the effects of climate change have continued to pose risks to supply chain operations. But from 2022/2023, firms operating in Germany, and the US had to invest more resources into managing the resilience and sustainability of their supply chains in the face of a more rigorous regulatory landscape governing corporate responsibility around the impact of human rights.³⁷

In Europe, the EC has proposed, and is currently negotiating, the Corporate Sustainability Due Diligence Directive, known as the CSDDD.³⁸ It is a broad-based reform that establishes a corporate due diligence duty for companies to identify, prevent, end or mitigate negative impacts of their operations on people and the environment.

The European Council finalised its position on the EC's draft of the CSDDD in December 2022.

Of particular interest to asset managers, one of the key changes made by the European Council to the EC's draft relates to financial undertakings. The European Council position is to leave it to individual Member States to decide whether they wish the regime to regulate the provision of financial services by financial undertakings, such as asset managers.

The European Parliament expects to finalise its own negotiating position on the proposal in March 2023 so that the official dialogue negotiations can commence after that.

UK Consumer Duty

The FCA has stated that at its heart, its new Consumer Duty will require a significant shift in both culture and behaviour by many firms. Setting higher standards and putting consumers' needs first is central to the FCA's strategy and the cornerstone of this is the Consumer Duty.

Since the publication of the final rules and guidance in July 2022,³⁹ the FCA has continued to provide firms with information and further clarity on the implementation of the Consumer Duty.

This has included speeches, sector specific webinars, updates to its Consumer Duty webpage (where the FCA explain more on areas of the Consumer Duty where it has



been receiving the most queries from firms), as well as its series of Inside FCA Podcasts and most recently the output from its multi-firm review and the asset management sector letter on implementing the Consumer Duty.⁴⁰

Most recently, on 22 February 2023, a speech by Sheldon Mills, Executive Director, Consumers and Competition at the FCA, entitled “Call of Duty – How putting customers front and centre will help industry innovate” summed up where firms are currently and what they still need to achieve.⁴¹

In terms of the key messages from Executive Director Mills speech, recommendations for firms are:

- Share information with their commercial partners and make sure they are on board, including the distribution network and wholesalers, as well as retailers and any third parties.
- To focus on the areas that will have the biggest impact on outcomes for customers. For example, making sure that your firm has narrowed its target market and that they can understand your communications.⁴²
- Consider if there are any cobwebs of bad practice that need clearing? Any punitive exit fees or unfair charges that need eradicating?
- The FCA also recommend firms look at the Pareto Principle, otherwise known as the 80/20 rule, that states that for many outcomes, some 80% of the consequences come from 20% of the causes.⁴³

As the 31 July 2023 deadline approaches for new and existing products or services that are open to sale or renewal, the FCA has stated it will continue to keep firms updated, particularly through its webpage on the Consumer Duty – information for firms.⁴⁴

Divergence, convergence and international cooperation

While market participants tend to focus on divergences and the risk of fragmentation, a recent ESMA speech highlighted areas of convergence in respect of certain aspects of financial markets regulation in the EU, the UK, and the US.⁴⁵

ESMA is not alone, as many national regulators are encouraging international cooperation, having regular

discussions with fellow regulators, and actively contributing to the important work led by the IOSCO and the FSB.

As a result, we see that whilst each jurisdiction is tailoring its path to its own regulatory framework, its toolbox and to the specificities of local markets, there are certain global themes, such as sustainable finance and financial innovation, that are ripe for further regulatory development.

What remains to be seen is whether international cooperation will further drive convergence in emerging regulatory standards or whether divergence will prevail.

¹ See <https://bills.parliament.uk/bills/3340>

² See [https://www.europarl.europa.eu/RegData/etudes/STUD/2023/740067/IPOLE_STU\(2023\)740067_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2023/740067/IPOLE_STU(2023)740067_EN.pdf)

³ See <https://www.legislation.gov.uk/ukpga/2000/8/contents>

⁴ See <https://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms>

⁵ See <https://www.fca.org.uk/publications/corporate-documents/future-regulatory-framework-review>

⁶ See <https://www.fca.org.uk/publication/discussion/dp23-2.pdf>

⁷ See <https://www.fca.org.uk/publication/correspondence/portfolio-letter-asset-management-2023.pdf>

⁸ Ibid, page 2.

⁹ See <https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>

¹⁰ See <https://www.fca.org.uk/publications/multi-firm-reviews/authorised-fund-managers-assessments-their-funds-value>

¹¹ See <https://www.fca.org.uk/firms/consumer-duty>

¹² See <https://www.fca.org.uk/publication/consultation/cp22-20.pdf>

¹³ See <https://www.fca.org.uk/publications/policy-statements/ps21-3-building-operational-resilience>

¹⁴ See <https://www.fca.org.uk/firms/investment-firms-prudential-regime-ifpr>

¹⁵ See <https://www.fca.org.uk/publications/multi-firm-reviews/ifpr-implementation-observations>

¹⁶ See https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan_en

¹⁷ See <https://www.fsb.org/wp-content/uploads/P200223-1.pdf>

¹⁸ See <https://www.gov.uk/government/consultations/future-financial-services-regulatory-regime-for-cryptoassets>

¹⁹ See <https://www.bankofengland.co.uk/news/2023/february/hm-treasury-and-boe-consider-plans-for-a-digital-pound>

- ²⁰ See <https://researchbriefings.files.parliament.uk/documents/CBP-8780/CBP-8780.pdf>
- ²¹ See <https://www.fca.org.uk/publications/discussion-papers/dp23-2-updating-and-improving-uk-regime-asset-management>
- ²² Direct to Fund (D2F).
- ²³ See <https://www.fsb.org/2022/10/achieving-greater-convergence-in-cyber-incident-reporting-consultative-document/>
- ²⁴ See <https://www.iosco.org/news/pdf/IOSCONEWS650.pdf>
- ²⁵ See <https://www.fca.org.uk/publications/discussion-papers/dp22-3-operational-resilience-critical-third-parties-uk-financial-sector>
- ²⁶ See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0595>
- ²⁷ See <https://www.sec.gov/rules/proposed/2022/ia-6034.pdf>
- ²⁸ See <https://www.reginfo.gov/public/do/eAgendaViewRule?publd=202210&RIN=3235-AM87>
- ²⁹ See <https://www.reginfo.gov/public/do/eAgendaViewRule?publd=202210&RIN=3235-AM88>
- ³⁰ See <https://www.sec.gov/rules/proposed/2022/33-11068.pdf>
- ³¹ Sustainable Finance Disclosure Regulation (SFDR): <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088>
- ³² See <https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/>
- ³³ See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0189>
- ³⁴ See https://www.esma.europa.eu/sites/default/files/library/ESMA22-106-4551_SMSG_additional_report_on_greenwashing.pdf
- ³⁵ See <https://www.fca.org.uk/publication/consultation/cp22-20.pdf>
- ³⁶ See <https://www.esma.europa.eu/press-news/esma-news/esas-launch-joint-call-evidence-greenwashing>
- ³⁷ See https://www.bgbli.de/xaver/bgbli/start.xav?startbk=Bundesanzeiger_BGBli&jumpTo=bgbli21s2959.pdf#__bgbli__%2F%2F*%5B%40attr_id%3D%27bgbli21s2959.pdf%27%5D__1678955494527 and <https://www.cbp.gov/trade/forced-labor>
- ³⁸ See https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en
- ³⁹ See <https://www.fca.org.uk/publications/policy-statements/ps22-9-new-consumer-duty>
- ⁴⁰ See <https://www.fca.org.uk/firms/consumer-duty>
- ⁴¹ See <https://www.fca.org.uk/news/speeches/call-duty-putting-customers-front-centre-industry-innovate>
- ⁴² See <https://www.fca.org.uk/multimedia/inside-fca-podcast-explaining-consumer-duty-consumer-understanding-outcome>
- ⁴³ This states that for many outcomes, some 80% of the consequences come from 20% of the causes.
- ⁴⁴ See <https://www.fca.org.uk/firms/consumer-duty-information-firms>
- ⁴⁵ See https://www.esma.europa.eu/sites/default/files/2023-04/ESMA74-1658524332-665_Natasha_Cazenave_Speech_TradeTech_2023.pdf

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Please contact for further details:

David Morrison

Global Head of Trustee and Fiduciary Services
david.m.morrison@citi.com
 +44 (0) 20 7500 8021

Ann-Marie Roddie

Head of Product Development Fiduciary Services
annmarie.rodzie@citi.com
 +44 (1534) 60-8201

Amanda Hale

Head of Regulatory Services
amanda.jayne.hale@citi.com
 +44 (0)20 7508 0178

Caroline Chan

APAC Head of Fiduciary Business
caroline.mary.chan@citi.com
 +852 2868 7973

Shane Baily

EMEA Head of Trustee and Fiduciary Services
 UK, Ireland and Luxembourg
shane.baily@citi.com
 +353 (1) 622 6297

Jan-Olov Nord

EMEA Head of Fiduciary Services
 Netherlands and Sweden
janolov.nord@citi.com
 +31 20 651 4313

www.citibank.com/mss

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