Thursday, 7 January 2016

Financial services regulation 2016: New Year briefing

As 2015 drew to a close, some in the media, apparently bored of recycling ever more stretched interpretations of the prophecies of Nostradamus, turned their attention instead to predictions supposedly made over many years by a Bulgarian mystic and clairvoyant called Baba Vanga, who died in 1996. Among the predictions attributed to her were the fall of the Soviet Union, the rise of Islamic State, the 2004 tsunami and the election of Barack Obama. Since a number of the things she is supposed to have predicted "came true", should we be concerned that she also said that, by the end of 2016, Europe will "cease to exist", leaving the continent a "wasteland"? Does this mean that, amongst other things, MiFID II will never take effect?

It is true that Brexit is a possibility that cannot be discounted. However, we will stick our necks out and predict that Europe will continue to exist throughout 2016 and beyond and that financial services regulation in the UK will continue to be heavily shaped by legislation from the EU. We also predict that, while a postponement to January 2018 now seems almost certain, MiFID II will nevertheless come into effect and this will be sooner than most firms would like.

In this briefing we summarise some key regulatory developments in the coming year (and beyond) on which firms should be focusing.

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1. MIFID II: A TWELVE MONTH REPRIEVE?

It now appears highly likely that the implementation of the entire recast Markets in Financial Instruments Directive ("**MiFID II**") legislative package will be delayed by 12 months until 3 January 2018, although this will still need to be confirmed by subsequent legislative amendment of the primary legislation.

However, given the significant technical challenges identified by the European Securities and Markets Authority ("**ESMA**") and the European Commission in ensuring that the new rules enter into force in a smooth and effective manner, it is clear that firms should not view the potential delay as a reason to postpone their own preparations for MiFID II. While a number of key implementing measures have not yet been finalised, in many areas it is at least possible to assess the broad implications for firms and the preparatory steps that can be taken.

In relation to those aspects of MiFID II that require domestic implementation, the Financial Conduct Authority ("**FCA**") published its first consultation paper in December 2015 (CP 15/43), covering markets-related issues. The consultation paper will be of particular relevance to operators of trading venues or systematic internalisers, as well as those firms that engage in algorithmic and/or high frequency trading. The deadline for responses is **8 March 2016**. The FCA has indicated that it expects to publish a second consultation paper in the first half of 2016 covering conduct of business issues.

Although a delay will be welcomed by much of the industry, firms should ensure that they use any reprieve to the maximum possible effect by continuing to plan and to progress their implementation work during the additional twelve months. Given that the proposed extended deadline is intended to address the technical and logistical difficulties of implementation, regulators are unlikely to be sympathetic to those firms which fail to ensure timely implementation by 3 January 2018.

2. MARKET ABUSE: THE INCOMING MAR REGIME

In under six months, on **3 July 2016**, the majority of the EU Market Abuse Regulation ("**MAR**") regime will be implemented. MAR, and its associated technical standards, will sweep away the existing market abuse regime and replace it with a set of directly applicable European laws. While the new regime builds on the existing Market Abuse Directive and therefore carries forward many concepts, there are some fundamental changes.

We have focused on three broad issues of immediate practical concern to asset managers in a separate briefing which is available here.

The key points to note about the new MAR regime are as follows:

- *No CSMAD please, we're British:* For the time being at least, the UK has decided not to opt into the "sister" EU legislation, the Directive on Criminal Sanctions for Market Abuse (known as CSMAD). Criminal sanctions in relation to any market conduct issues will therefore continue to be governed by existing UK legislation.

- *Stepping up with new platforms:* MAR will apply to a wider range of instruments traded on a wider range of market venues. It will cover abusive behaviour not only in relation to financial instruments admitted to trading on a regulated market or for which a request for admission has been made (as now), but also financial instruments admitted to trading on a multilateral trading facility ("**MTF**") or in respect of which a request for admission has been made (although some domestic MTFs are already caught under the existing UK market abuse regime). When MiFID II eventually comes into effect the new regime will go further to capture also financial instruments admitted to trading on an organised trading facility ("**OTF**").

- *Spot the difference:* Transactions, orders or behaviour in relation to spot commodity contracts (which are not wholesale energy products) will be caught by the market abuse regime for the first time, to the extent that they have, or are intended to have an effect on the price or value of a financial instrument traded on a regulated market or MTF (or, in due course, OTF). Similarly, any transaction, order, bid or behaviour in relation to a financial instrument which has, or is likely to have, an effect on the price or value of a spot commodity contract whose price or value is linked to the price or value of that financial instrument will be subject to the regime.

- *Sitting on the benchmarks:* Behaviour in relation to benchmarks is within the market manipulation provisions of MAR. While the UK already regulates (and will continue to regulate) criminal market misconduct in relation to a set of specified benchmarks (including LIBOR, WM/Reuters 4 p.m. London Fix (the main global foreign exchange benchmark) and ISDA Fix (the principal global benchmark for swap rates and spreads for interest rate swaps)), the definition of "benchmark" in MAR is much broader.

- *Is it on the list?:* ESMA will be required to publish on its website a consolidated list of notifications it has received from the various market operators of the admitted and traded financial instruments. This list will be in an electronic, downloadable and machine readable form.

- *How to take soundings:* MAR, and its detailed regulatory technical standards, set out some stringent requirements on "disclosing market participants" (including sell-side brokers) in the context of market soundings. (Draft regulatory technical standards ("**RTS**") were delivered to the Commission in ESMA's Final Report on 28 September 2015.) Recipients of market soundings are also required to assess for themselves (independently of the disclosing market participant's view) whether they are in possession of inside information or when they cease to be in possession of such information. In addition, ESMA is expected to issue a consultation paper in **Q1 2016** on **Level 3 guidelines** that will be specifically addressed to the buy-side recipients of market soundings. These will address the factors that recipient firms should take into account when information is disclosed to them in order to assess whether the information amounts to inside information, the steps that recipient firms should take if inside information has been disclosed to them and the records that recipient firms should maintain to show that they have complied with the insider dealing and unlawful disclosure provisions of MAR.

- *Check (auto)mate:* MAR requires trading venues and firms which arrange or execute transactions to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. While not yet agreed by the Commission, the draft regulatory technical standards which ESMA has delivered, together with its commentary, suggest that, in the large majority of cases, regulators will expect to see an automated surveillance system of some kind. There is a nod to proportionality and a recognition that automation may not be appropriate in every case, but firms - particularly smaller firms, with only limited exposure to in-scope instruments and little or no automation in their surveillance systems at the moment - will need to keep an eye on this issue.

- *STORs for shopping:* Broadly, where a firm has a reasonable suspicion that an order or transaction in any financial instrument admitted to trading on a regulated market or MTF (or, when MiFID II comes into force, OTF) (or any cancellation or modification of an existing order or transaction) could constitute insider dealing or market manipulation (or an attempt at either offence), it will be required to submit a Suspicious Transaction and Order Report ("**STOR**") to its regulator in the form of a template set out in Level 2 regulatory technical standards. As the name suggests, there will be a new, explicit obligation to report suspicions in relation to orders, even if they do not proceed to execution. The FCA is currently building a platform for the receipt of STORs.

On 5 November 2015, the FCA published its consultation paper on amendments to the Handbook to accommodate the introduction of MAR (CP15/35: Policy proposals and Handbook changes related to the implementation of the Market Abuse Regulation (2014/596/EU)). Amongst other things, the FCA proposes to retain Chapter 1 of the Market Conduct sourcebook, although this will be heavily amended and will no longer be referred to as the Code of Market Conduct (as the statutory provision requiring the FCA to publish such a code will be deleted). Somewhat confusingly, the sourcebook will still be abbreviated as "MAR". Broadly speaking, the FCA is proposing to set out guidance on matters governed by what the FCA refers to as "EU

MAR" where such guidance does not conflict with the EU Regulation. The consultation is still open - until **4 February 2016** - if firms wish to respond, either direct or through trade associations.

3. EU SECURITIES FINANCING TRANSACTIONS REGULATION

On 23 December 2015, the Securities Financing Transactions Regulation (Regulation (EU) 2015/2365) ("**SFTR**") was published in the EU Official Journal and will therefore enter into force on 12 January 2016, although certain obligations under the SFTR will apply in a phased manner, as explained below.

The SFTR is part of the EU's wider "shadow banking" regulatory agenda and has been partially modelled on the European Market Infrastructure Regulation ("**EMIR**"), introducing new reporting and record keeping requirements in connection with the use of securities financing transactions ("**SFTs**"), although some of the requirements are wider in scope. For the purposes of the SFTR, an SFT is defined as any of the following:

- a repo or reverse repo;
- a buy-sell back or sell-buy back transaction;
- a securities or commodities borrowing or lending transaction; or
- a margin lending transaction (although this concept is broadly defined in the SFTR).

In addition to the reporting and record keeping requirements, the SFTR also includes new investor transparency requirements applying to AIFMs and UCITS managers in connection with their use of SFTs and total return swaps on behalf of the AIF or UCITS funds that they manage, as well as new requirements for collateral takers to obtain consent to the re-use of collateral in the form of financial instruments. It is important to note that the collateral requirements are <u>not</u> limited to the receipt and re-use of collateral in connection with SFTs.

We have set out below a high level summary of each of the relevant obligations and their application dates.

PRE-CONTRACTUAL INVESTOR DISCLOSURES

From **12 January 2016**, above-threshold EU AIFMs and UCITS managers will need to include additional information in the AIF pre-contractual disclosures or in the UCITS prospectus for any AIF or UCITS fund <u>constituted on or after that date</u>. That information must set out the SFTs and total return swaps that the AIFM or UCITS manager is authorised to use in connection with the AIF or UCITS fund and must include certain other detailed disclosures mandated by the SFTR.

For AIFs or UCITS funds <u>constituted prior to 12 January 2016</u>, the pre-contractual disclosure obligation will not apply until **13 July 2017**. This means that it will be less relevant for those existing closed-ended funds in respect of which marketing has ceased by that date.

RECORD KEEPING REQUIREMENT

Also from **12 January 2016**, new record keeping requirements will apply to:

- any EU counterparty to an SFT, including any branches of such a counterparty, irrespective of where they are located; and
- any non-EU counterparty to an SFT where the SFT was concluded in the course of operations of an EU branch of that counterparty.

For the purposes of the SFTR, the term "counterparty" includes any undertaking, whether regulated or unregulated, but excludes individuals acting for private purposes. The record of the conclusion of an SFT, as well as records of any subsequent modification or termination of the transaction, must be maintained for at least 5 years following its termination.

REQUIREMENTS RELATING TO REUSE OF COLLATERAL

From **13 July 2016**, new disclosure and consent requirements will apply to:

- any EU counterparty engaging in reuse of collateral, including any branches of such a counterparty, irrespective of where they are located; and
- any non-EU counterparty engaging in reuse of collateral where either:
    - the reuse is effected in the course of the operations of an EU branch of that counterparty; or
    - the reuse concerns financial instruments provided under a collateral arrangement by an EU counterparty or an EU branch of a non-EU counterparty.

As mentioned above, these requirements relating to the reuse of collateral are <u>not</u> limited to the reuse of collateral in the context of SFTs. For these purposes, the term "reuse" refers to any use by a counterparty of collateral in the form of financial instruments that it has received under either a security financial collateral arrangement ("**SFCA**") or a title transfer collateral arrangement ("**TTCA**") as defined in the EU Financial Collateral Arrangements Directive. This includes the use or disposal of the collateral by the receiving counterparty for its own account or for the account of another person, but excludes the liquidation of the collateral as a result of the default of the counterparty that provided it.

The precise obligations vary depending upon whether the arrangement is an SFCA or a TTCA, but in both cases the counterparty receiving the collateral is required to disclose the risks to the counterparty providing the collateral that will result from granting consent to a right of reuse of the collateral under the SFCA or concluding the TTCA. In addition, the SFTR requires the receiving counterparty to obtain the prior express written (or equivalent) consent of the providing counterparty to the conclusion of an SFCA involving a right of reuse of the relevant collateral or to the conclusion of a TTCA. There is also a requirement that the financial instruments received under a collateral arrangement must be transferred from the account of the providing counterparty (although this would normally be the case anyway), subject to a potential derogation from this rule for accounts maintained in, and subject to the law of, a non-EU country.

The SFTR states that the collateral reuse obligations will apply to any collateral arrangements existing on 13 July 2016. Although ambiguous, this appears to mean that historic collateral arrangements that remain outstanding on that date will need to comply with the new rules immediately, which may require counterparties to provide additional risk disclosures and/or to obtain additional written consents prior to that date in order to ensure timely compliance.

PERIODIC INVESTOR DISCLOSURE REQUIREMENTS

From **13 January 2017**, above-threshold EU AIFMs and UCITS managers will need to include additional disclosures in the AIF annual report and in the half-yearly and annual reports of UCITS funds in connection with the AIF or UCITS fund's use of SFTs and total return swaps. The precise range of information that must be included is set out in the SFTR and is relatively detailed in nature.

SFT REPORTING REQUIREMENT

The SFTR will require reporting of SFTs to a trade repository (which is registered or recognised in accordance with the SFTR) by:

- any EU counterparty to an SFT, including any branches of such a counterparty, irrespective of where they are located; and

- any non-EU counterparty to an SFT where the SFT was concluded in the course of operations of an EU branch of that counterparty.

The application date of the reporting obligation depends upon two key factors: first, the date on which ESMA's Level 2 measures enter into force following their adoption by the European Commission, and secondly, the precise regulatory status of the counterparty to the SFT. At the present time, it appears unlikely that the reporting obligation will apply to any category of counterparty prior to **Q1 or Q2 2018**.

Generally, the reporting obligation will only apply to those SFTs that are concluded by a counterparty on or after the date on which it becomes subject to the reporting requirement. However, there is also a limited "back-filling" requirement whereby a counterparty must report any SFTs entered into prior to that date if:

- the SFT remains outstanding on that date; and

- the remaining maturity of the SFT on that date exceeds 180 days (or, if the SFT has an open maturity, the SFT remains outstanding 180 days after that date).

If a counterparty is subject to the back-filling requirement, the SFT must be reported within 190 days of the date on which it became subject to the reporting obligation.

The details of any conclusion, modification or termination of an SFT must be reported to a trade repository authorised under the SFTR no later than the working day following such conclusion, modification or termination (i.e. on a T+1 basis). The precise details that must be reported will be specified by ESMA in Level 2 measures.

The SFTR specifically provides that where an AIF or UCITS fund is the principal counterparty to an SFT, the relevant AIFM or UCITS manager is responsible for the submission of the report on the fund's behalf.

There is a limited exception to the reporting obligation that applies to certain small and medium-sized undertakings ("**SMEs**") which conclude an SFT with certain regulated counterparties. Where the exception applies, the regulated counterparty is responsible for submitting a report both on its own behalf and on the behalf of the SME.

In addition, any transaction to which a member of the European System of Central Banks ("**ESCB**") is a counterparty is not subject to the reporting requirement – i.e. neither counterparty is required to report such a transaction.

Certain counterparties are also exempt from both the SFT reporting requirement and the collateral reuse requirements mentioned above. These include members of the ESCB and other bodies of EU Member States that perform similar functions, as well as the Bank for International Settlements.

4. EMIR – COUNTERPARTIES, CLEARING AND COLLATERAL – 2016 AND BEYOND

MANDATORY CENTRAL CLEARING – FIRST PHASE – INTEREST RATE DERIVATIVES

More than three years after the first risk mitigation obligations under EMIR came into force, mandatory central clearing of certain OTC derivatives will finally commence later this year. For clearing members of CCPs this will start on 21 June 2016. Other firms subject to the clearing obligation will have just under 12 months, 18 months or 36 months respectively from 21 December 2015 to prepare, depending upon their categorisation.

The first wave of mandated classes of OTC derivatives contracts are: basis swaps, fixed-to-floating interest rate swaps, forward rate agreements and overnight index swaps denominated in certain currencies and with certain maturities.

Those who will be caught by the clearing obligation include: credit institutions, MiFID investment firms, UCITS and their management companies, AIFs managed by authorised or registered AIFMs and AIFs managed by AIFMs that are not authorised or registered AIFMs but whose OTC derivatives trading is above a "clearing threshold".

Except where they are clearing members of an authorised or recognised CCP (in which case the start date is 21 June 2016) the relevant start date for all of the above will either be **21 December 2016** or **21 June 2017** depending on the level of non-centrally cleared OTC derivatives trading undertaken. It will be the earlier of the two dates if the relevant entity is not an AIF or UCITS and belongs to a *group* whose aggregate month-end average of outstanding gross notional amount of all non-centrally cleared derivatives transactions for January, February and March 2016 is above EUR 8 billion. In the case of UCITS and AIFs the same calculation is done but at the level of the fund only. If the result of the average calculation is EUR 8 billion or below, the start date will be 21 June 2017. Finally, for any non-financial counterparty above the clearing threshold and which is not an AIF or a clearing member, the start date will be 21 December 2018.

Financial counterparties (including AIFs managed by authorised or registered AIFMs) and non-financial counterparty AIFs above the clearing threshold will need to record the month-end gross notional amount as at 31 January, 29 February and 31 March 2016 to determine which category they are in and to be able to evidence that determination.

Firms subject to the clearing obligation will need clearing arrangements in place in order to meet the relevant clearing deadline. In practice this will mean becoming a client, or indirect client, of a clearing member; this will entail entering into documentation with a clearing services provider.

We have a briefing which provides a more detailed explanation of this first phase of mandatory central clearing, which is available to clients on request to Carol Durndell at carol.durndell@traverssmith.com.

MANDATORY CENTRAL CLEARING – MORE PHASED IMPLEMENTATION FOR OTHER ASSET CLASSES TO COME

There are other clearing obligation technical standards in the pipeline. ESMA has now delivered its Final Reports to the European Commission with draft RTS for endorsement in relation to the following asset classes:

- credit derivatives (Final Report, 1 October 2015); and
- forward rate agreements and fixed-to-floating interest rate swaps denominated in Norwegian Krone (NOK), Polish Zloty (PLN) and Swedish Krona (SEK) (Final Report, 10 November 2016).

Each draft RTS adopts a similar phased implementation approach to that used in the first phase RTS (see above), so that clearing members of CCPs will be required to clear first, with other categories, based on their legal and operational capabilities, having longer to prepare. As before, the relevant start date for UCITS and their management companies, AIFs managed by authorised or registered AIFMs and AIFs managed by AIFMs that are not authorised or registered AIFMs but whose OTC derivatives trading is above a "clearing threshold" will depend on the level of non-centrally cleared OTC derivatives trading undertaken averaged over three month-ends – those whose aggregate month-end average of gross notional amount of all non-centrally cleared derivatives transactions exceeds EUR 8 billion will find themselves having to clear earlier.

Now the drafts are with the Commission it is difficult to predict with any certainty when clearing in respect of these additional classes will become mandatory for in-scope counterparties.

There are no proposed RTS at this stage in relation to non-deliverable forwards or lookalike/flexible equity derivatives and contracts for difference.

RISK MITIGATION REQUIREMENTS – MARGIN AND COLLATERAL

While mandatory clearing of OTC derivatives will finally start to become a reality later this year, it is important to remember that EMIR's risk mitigation requirements continue to apply to all OTC derivative transactions that are not centrally cleared – and despite the introduction of mandatory clearing in respect of the prescribed standardised classes, there will still be many OTC derivatives which will not be capable of or subject to central clearing. The legislation for most of these risk mitigation requirements has been in place for some time and in-scope firms should be complying with them. However, there is one issue of substance that remains outstanding. This relates to the exchange of collateral and bilateral margining – these margin requirements will apply to financial counterparties (including AIFs managed by an authorised or registered AIFM) and to non-financial counterparties above the prescribed "clearing threshold".

In their Second Joint Consultation Paper issued in June 2015, the European Supervisory Authorities ("**ESAs**"), set out revised draft RTS prescribing the minimum amount of initial margin and variation margin to be posted and collected by the in-scope counterparties to cover the mark-to-market exposures of non-cleared OTC derivative contracts and the methodologies by which that amount would be calculated. The draft RTS also address eligible collateral.

The proposal is to phase-in the initial margin requirements over a four-year period, with only the very largest of trading counterparties – i.e. where *both* counterparties have or belong to groups, *each* of which has an aggregate average *gross* notional amount of non-centrally cleared derivatives of above EUR 3.0 trillion (taken over three month-ends) – becoming subject to the initial margin requirements at the outset (currently on 1 September 2016). The final phase of implementation of the initial margin requirements would be complete on 1 September 2020 when the obligations would apply to transactions where *both* counterparties have or belong to groups, *each* of which has an aggregate average *gross* notional amount of non-centrally cleared derivatives of above EUR 8 billion. Any covered counterparty below the EUR 8 billion threshold would not be required to post initial margin.

Phased implementation of the variation margin requirements will be more truncated: all the very largest trading counterparties (i.e. where *both* counterparties have exceeded the EUR 3.0 trillion threshold referred to above) would be required to comply from 1 September 2016, whereas all the other covered counterparties would have to comply from 1 March 2017.

The margin requirements would not apply to OTC derivatives transactions which are entered into before the relevant phase-in date.

The EMIR margining requirements remain a work in progress while we wait for the final text of the RTS, which are expected to be published in early 2016. Once the RTS are finalised, we will have more visibility as to how the margin requirements are to be implemented by market participants – this will include further details as to:

- how the initial margin and variation margin structures will be documented by the relevant parties (e.g. in respect of initial margin, it is expected that the parties will be required to set up a security arrangement that provides for the segregation of the assets posted as a collateral); and

- the applicability of the margin requirements (e.g. as currently drafted, the RTS provide that the exchange of variation margin without initial margin should be considered as appropriate exchange of collateral for selected physically-settled FX products).

5. EBA FINAL GUIDELINES ON SOUND REMUNERATION POLICIES UNDER CRD IV

On 21 December 2015, the European Banking Authority ("**EBA**") published its long-awaited final guidelines on sound remuneration policies under the EU Fourth Capital Requirements Directive ("**CRD IV**") (EBA/GL/2015/22).

The new guidelines and the EBA's accompanying explanatory text are clear that the maximum 2:1 ratio of variable to fixed remuneration (sometimes termed the "bonus cap") must be applied by all firms that are subject to CRD IV and cannot be disapplied on the grounds of proportionality. This differs from the current UK position in the FCA's guidance to the CRD IV (SYSC 19A) Remuneration Code, which states that the bonus cap may generally be disapplied by smaller and less complex institutions.

The guidelines will apply from 1 January 2017 and if the PRA and FCA indicate that they will comply with them, it appears likely that the bonus cap will therefore apply to CRD IV firms in respect of each full performance period beginning on or after that date.

In addition, the PRA and FCA (in common with many other EU supervisory authorities) currently permit CRD IV firms to disapply certain other "pay-out process rules", which relate to the deferral of a minimum proportion of variable pay and the payment of variable pay in financial instruments, on the grounds of proportionality. Although the new EBA guidelines do not, on their strict wording, expressly forbid such an approach, the EBA has published a separate opinion (EBA/Op/2015/25) which sets out proposed legislative changes to the text of CRD IV. It appears that these proposed changes are intended to specify an exhaustive list of rules which may be disapplied by institutions which are deemed to be small and non-complex (i.e. on the grounds of proportionality). The opinion also suggests to the European Commission that the EBA could be given a mandate to determine the specific criteria by which an institution could be categorised as small and non-complex in this context and therefore would be eligible to take advantage of the specified proportionality exceptions. If these legislative proposals are enacted, this could mean that many firms which currently disapply the pay-out process rules on proportionality grounds would need to apply those rules for the first time.

We recently published a full briefing on the EBA guidelines and opinion, which is available here.

6. EBA PROPOSED GUIDELINES ON REMUNERATION POLICIES FOR RETAIL BANKING PRODUCTS AND SERVICES

On 22 December 2015, the EBA published a consultation paper containing draft guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services (EBA/CP/2015/29).

The proposed guidelines will be relevant to financial institutions that provide services such as deposit accounts, credit facilities, payment services or e-money services to consumers. They are designed to ensure that such firms design and implement remuneration policies that protect the interests of consumers by minimising employee conduct risk that could result from remuneration practices and addressing conflicts of interest that may arise between the interests of the institution and/or its employees and those of consumers.

The proposed new guidelines would apply from 3 January 2017. Firms have until **22 March 2016** to submit any consultation responses.

7. EBA REPORT ON THE PRUDENTIAL TREATMENT OF INVESTMENT FIRMS

On 14 December 2015, the EBA published its report on the prudential treatment of investment firms (EBA/Op/2015/20) in response to the European Commission's call for advice in December 2014. It is intended that the Commission will take into account the EBA's advice when it prepares its own formal report evaluating various aspects of the prudential regime for investment firms under the EU Capital Requirements Regulation ("**CRR**").

The EBA's report is an extensive and considered document, covering a large number of aspects relating to the interaction between MiFID and the CRD IV regime. By way of a brief summary of the key issues in the report, the EBA proposes the following:

- A proposed future three-tiered prudential regime for MiFID investment firms, divided between:
    - Firms that are substantial undertakings and undertake "bank-like" intermediation and underwriting of risks on a significant scale;
    - Less complex firms undertaking investment business that pose specific risks to investors and to other market participants; and
    - Small, non-interconnected firms that can be governed by a simple regime that permits them to be wound down in an orderly manner;

- The categorisation of firms by reference to the systemic importance of the investment firm (determined by reference to consistent qualitative and quantitative indicators), rather than predominantly by reference to the MiFID activities carried on by the firm, as at present;

- A prudential regime for non-systemically important firms that takes particular account of the risks associated with holding client money and securities;

- The potential application of a modified large exposures regime to smaller firms; and

- Continuing the existing exemption from CRR capital adequacy requirements and large exposures rules for commodity dealers until any new prudential regime is implemented.

The EBA has suggested that it should carry out a data collection exercise, followed by a second report, providing more in-depth details in relation to these proposals. As the full implications of the new regime will depend upon the precise details of the revised rules, firms should continue to monitor developments in this area and should pay close attention to any follow-up work published by the EBA.

The EBA appears to be proposing higher capital requirements for investment firms. Any modified regime may have a significant impact on the amount of regulatory capital that firms are required to hold and the specific rules to which they are subject. In particular, it should be noted that revision of the existing prudential regime could also affect the status of exempt-CAD firms, who currently fall outside of the CRR regime, and BIPRU firms, who currently benefit from the ability to comply with pre-2014 CRD III rules. As a result, the EBA and European Commission's work in this area will be of interest to a wide range of firms and not only those currently within the scope of CRD IV.

8. EBA GUIDELINES ON LIMITS ON EXPOSURES TO SHADOW BANKING ENTITIES

Also on 14 December 2015, the EBA published its final 'Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework' (EBA/GL/2015/20), following its earlier consultation paper in March 2015.

The guidelines set out the approach to the application of limits in connection with exposures to entities deemed to be "shadow banking entities" by the EBA and (subject to the FCA and PRA confirming that they intend to comply with the guidelines) will apply from 1 January 2017, although firms that are impacted by them may need to take preparatory action prior to that date. For these purposes, a shadow banking entity is defined very broadly as an undertaking that carries out one or more credit intermediation activities, but that definition is then narrowed by a series of specific exclusions. Potentially, this definition could cover a large number of entities that engage in lending, use significant leverage or are involved in credit risk transfer, including relevant investment funds and their transaction vehicles.

The guidelines are only directly applicable to firms that are subject to the large exposures regime under the CRR – i.e. in the UK, those firms that are currently classified as full-scope IFPRU investment firms or credit institutions. Such firms will need to review the new requirements introduced by the guidelines and introduce new policies or amend their existing policies accordingly. In addition, it is likely that they will need to obtain increased information in relation to counterparties or investee entities to which they have exposures that exceed the applicable *de minimis* threshold.

Entities that fall within the definition of a shadow banking entity, but which are not subject to the CRR large exposures regime, may therefore still be indirectly affected by the guidelines, as they may need to make additional information available to credit institutions or full-scope IFPRU firms (or their equivalents in the rest of the EU) in order to facilitate compliance by those firms with the relevant provisions. In addition, it is also possible that firms that are directly subject to the guidelines may determine that they need to limit or reduce their future material exposures (whether arising through lending or investment) to shadow banking entities as a result of the new rules.

9. FCA ADOPTION OF EBA GUIDELINES ON MATERIALITY, PROPRIETARY INFORMATION, CONFIDENTIALITY AND FREQUENCY OF DISCLOSURES

On 14 October 2015, the EBA's guidelines on materiality, proprietary information, confidentiality and disclosure frequency (EBA/GL/2014/14) came into effect for PRA and FCA-regulated firms that are subject to the CRD IV regime.

These guidelines outline the criteria and processes that should be applied when firms within the scope of CRD IV are determining whether they can omit information from their Pillar 3 disclosures on the basis that such information is immaterial and/or is proprietary and confidential in nature. In addition, the guidelines also set out the circumstances in which firms should make Pillar 3 disclosures more frequently than on an annual basis, although this aspect is likely to be relevant to the largest of institutions only. The guidelines are not applicable to BIPRU firms, which should continue to produce their Pillar 3 disclosures in accordance with the BIPRU rules and the FCA's existing guidance.

Firms that are subject to the CRD IV Pillar 3 rules are likely to need to amend their existing Pillar 3 disclosure policies or to draft new policies taking into account these new criteria and processes. In particular, firms should ensure that they document fully the rationale for the omission of any information from the Pillar 3 disclosure document, either on the grounds of materiality or on the basis that the relevant information is proprietary and confidential, in case of subsequent supervisory review.

10. PRIIPs – COUNTDOWN TO IMPLEMENTATION ON 31 DECEMBER 2016

Now that 2016 is here, firms involved in the manufacture or sale of packaged retail investment and insurance products will need to re-focus their efforts on preparing for the implementation of the PRIIPs Regulation at the end of the year – it becomes effective on **31 December 2016**.

The PRIIPs Regulation requires manufacturers of packaged retail investment products or insurance based investment products ("**PRIIPs**") – including investment funds, life insurance policies with an investment element, structured investments and deposits and certain instruments issued by special purpose vehicles - to prepare and publish a Key Information Document ("**KID**") *before* the PRIIP is made available to retail investors. The purpose of the KID is to improve transparency for retail investors by providing them with a short document containing key information about the product, which will enable them to make informed investment decisions and which is presented in a common format to facilitate comparability.

In November 2015, the ESAs issued a Consultation Paper on the draft regulatory technical standards for the presentation, content, review and provision of the KID. These standards contain the detailed requirements which will have to be complied with when producing the KID including the methodologies to be used to calculate the summary risk indicator, the presentation of performance scenarios and information on costs. The content of the KID is heavily prescribed and firms will need to ensure that they can provide the required information, calculated in the prescribed manner.

The consultation paper is open for comment until **29 January 2016** and we expect the final draft of the regulatory technical standards to be submitted to the European Commission by 31 March 2016.

Although the draft regulatory technical standards are not yet final, they provide firms with a clear indication of the types of information and data which will be required to produce the KID. Given that there is no transitional relief for existing products (other than UCITS), firms with significant retail product lines should be preparing in earnest now.

11. UCITS V – READY FOR MARCH?

UCITS V is due to take effect on **18 March 2016**. This Directive amends the existing UCITS framework in two key areas: UCITS manager remuneration and the depositary's obligations and liability.

Despite the fact that there are just over two months until the effective date of the Directive, the ESMA Guidelines in relation to UCITS manager remuneration have not yet been finalised and the Level 2 Commission delegated regulation to implement the detailed depositary provisions of UCITS V was only published just before Christmas.

The delegated Regulation will come into force 20 days after its publication in the Official Journal (which has yet to happen) but even then will not become effective in Member States until 6 months later. The earliest that the Regulation could take effect, therefore, assuming imminent publication, is July 2016. It would appear that UCITS managers and depositaries will have to comply with the high level duties and obligations set out in the Directive as from 18 March 2016 but not the detailed provisions of the delegated Regulation until it too becomes effective.

Whilst this may present some challenges, depositaries are likely to welcome the slightly extended timeframe within which to comply with the detailed provisions of the delegated Regulation, particularly those relating to the terms of their contract with the UCITS manager, the conditions governing the delegation of custody functions and the requirements in relation to the protection of the UCITS' assets held in third countries on insolvency. The last set of requirements will include an obligation to obtain legal opinions; the recitals to the Regulation contemplate that these may be organised on a jurisdiction-by-jurisdiction basis by industry associations or law firms for the benefit of several depositaries.

As far as UCITS manager remuneration is concerned, we anticipate that ESMA's guidelines on remuneration will be issued shortly. Many UCITS managers will already have in place a remuneration policy but this will need to be revised and updated to comply with the detailed requirements in ESMA's guidelines.

12. MONEY LAUNDERING: MLD 4

The Fourth Money Laundering Directive ("**MLD 4**") was published on 5 June 2015 and must be transposed into Member States' national law by **26 June 2017**.

Implementation of MLD4 does not take place until 2017. However, a number of details by way of technical standards, delegated acts and guidelines are being developed between now and then. Consultations on Level 2 and Level 3 measures are open until later this month and H.M. Treasury is shortly due to consult on implementation measures. Firms should be aware of the following headline points:

- *Farewell JMLSG … ?* The three European Supervisory Authorities (ESAs) issued a joint consultation paper on 21 October 2015 which, amongst other things, expanded on the risk factors that firms must consider and the measures to be taken where simplified CDD measures are appropriate (the Risk Factors Guidelines). In terms of outline format at least, these draft Level 3 guidelines do not look dissimilar to the approach adopted by the Joint Money Laundering Steering Group ("**JMLSG**") Guidance Notes, with a general section on assessing and managing risk and a separate section of sector-specific guidelines. However, while they may be modelled on the JMLSG Guidance Notes in terms of structure at least, they are considerably less detailed and the choice of "sectors" is a good deal less granular – only nine such sectors are proposed. For instance, while there are brief sectoral guidelines for "investment managers", there is nothing express in relation to the private equity/venture capital industry. Other sectors addressed by the JMLSG Guidance Notes but not contemplated by the draft Risk Factors Guidelines include: corporate finance, execution-only stockbrokers, consumer credit providers, syndicated lending, wholesale markets and invoice finance. Competent authorities and financial institutions will be required to make every effort to comply with the Guidelines once finalised. Whether there will be a place for more detailed JMLSG Guidance under the MLD4 regime largely depends on how H.M. Treasury proposes to implement the Directive and, in deciding whether a person has failed to comply with the legislation, what guidance the courts will be required to consider. If Level 3 guidelines from the ESAs are all there will be, the current consultation assumes critical importance: firms should note that the consultation paper on the Risk Factors Guidelines remains open until **22 January 2016**. Firms should consider responding direct, or through their relevant trade association. Following responses, the Risk Factors Guidelines are "likely to be finalised in Spring 2016".

- *Obliged (and obligated):* Firms subject to MLD4 will be referred to, rather inelegantly, as "obliged entities". Firms currently subject to the Money Laundering Regulations 2007 ("**MLRs**") will remain in scope (and there is some expansion of scope to catch "providers of gambling services", not just casinos and the threshold for a trader in high value goods will drop to EUR 10,000 (from EUR 15,000)).

- *Risk assessment:* The Directive will have an increased focus on risk assessment and use of the risk-based approach. Firms will be required to take appropriate steps to identify and assess the risks of money laundering and terrorist financing, taking into account a variety of risk factors – customers, countries or geographic areas, products, services, transactions or delivery channels. These steps must be proportionate to the nature and size of the obliged entities. Risk assessments must be documented, kept up-to-date and made available to relevant regulators. Firms must have in place proportionate policies, controls and procedures to mitigate and manage effectively the risks of money laundering and terrorist financing. Approval for such policies, controls and procedures must be obtained from senior management. All this should sound familiar to UK firms which are complying with existing requirements under the MLRs and FCA systems and controls rules; and should therefore not necessitate a major overhaul of existing practices. That said, it would be wise to conduct a gap analysis later in the year to test such practices against MLD 4 and the UK implementing provisions.

- *No more "automatic" SDD exemptions:* Firms are currently allowed to apply simplified due diligence for certain categories of customer (e.g. credit and financial institutions subject to MLD3 (or equivalent) and EEA listed companies). In truth, although the MLRs refer to simplified due diligence as meaning not having to apply CDD measures in certain circumstances, the "exemptions" have never been "automatic" as such because the right has always been subject to the risk having been assessed as appropriately low and (as the FCA has made clear) the obligation to carry out enhanced due diligence will always apply if the circumstances dictate (e.g. in a situation which by its nature can present a higher risk of money laundering or terrorist financing). In any event, MLD4 will do away with any suggestion of an automatic exemption: instead, firms will be required, *before* applying simplified due diligence, to ascertain that the customer relationship or transaction presents a lower degree of risk. In doing so, firms will be required to take into account a number of prescribed factors. An annex to MLD4 sets out a non-exhaustive list of factors and types of evidence of "potentially lower risk". The three European Supervisory Authorities (ESAs) issued a joint consultation paper on 21 October 2015 expanding on the risk factors that firms must consider and the measures to be taken where simplified CDD measures are appropriate. Firms will need to re-examine their systems and procedures to ensure that the use of simplified due diligence is not an "automatic", box-ticking exercise and that it will be able to show the regulator evidence of the *ex-ante* risk assessment it conducted in respect of a particular customer.

- *PEP talk:* The list of politically exposed persons will be expanded to include members of the governing bodies of political parties and directors, deputy directors and members of the board or equivalent function of an international organisation. Furthermore, persons who are entrusted with prominent functions <u>*in the UK*</u> will be caught (currently they are excluded from the definition).

- *White to black:* In keeping with the move towards a more risk-based approach, MLD4 does away with the idea of having a list of third countries considered by EU Member States to have equivalent anti-money laundering and counter-terrorist financing systems, the so-called "white list". In future, under MLD4, there will instead be a "black list" – a list of "high-risk third countries" identified by the European Commission as having strategic deficiencies and published by way of a delegated act. Third countries not included on the Commission's black list – including those which are currently assessed as equivalent and appear on the "white list" – should not automatically be considered to have effective AML/CFT systems, and natural persons or legal entities established in such countries should be assessed on a risk-sensitive basis.

- *Electronic money derogation:* There are some changes of detail to the conditions which must be satisfied for the electronic money derogation to apply (which will, broadly, make it harder to rely on). Firms which currently rely on this derogation should examine the changes carefully.

- *Beneficial ownership registers:* Under MLD4 all companies, incorporated legal entities and trustees of express trusts will be required to obtain and hold information on their beneficial ownership. This information is to be made available to other regulators and financial intelligence units, obliged entities when carrying out CDD activities and any person or organisation that can demonstrate a "legitimate interest", and is to be held on a central register. The UK has already pre-empted the beneficial ownership register requirements of MLD4 to a degree by introducing a requirement for all Companies Act companies and LLPs to have a "PSC Register" under the Small Business, Enterprise and Employment Act 2015. Implementation of the UK regime will take place in April 2016, with a filing deadline of June 2016. In some ways the UK regime goes beyond the requirements of MLD4 (for instance, in terms of the details of how to determine beneficial ownership) but will nonetheless require some amending in readiness for MLD4 implementation – for instance, the UK regime does not currently address the position of trusts.

13. PSD 2: TWO YEARS TO GO

Amid the usual pre-Christmas rush, Directive (EU) 2015/2366 on payment services in the internal market ("**PSD 2**") was quietly published in the Official Journal. The UK and other EU Member States must transpose the Directive into their national laws from **13 January 2018** (and the existing Payment Services Directive will be repealed as of that date). However, the new security provisions in PSD 2 (see below) will come into force 18 months after the adoption of regulatory technical standards which will be developed by the EBA in due course.

PSD 2 will enhance the existing electronic payment services framework in the UK. Changes that PSD 2 will usher in will include the following:

- *Scope – two-legs good, but two-legs and one-leg better:* certain provisions in PSD 2 dealing with transparency of terms and conditions, customer information and other conduct of business requirements will apply to payment transactions *in all currencies*, including where *only one* of the payment service providers is located in the EU (a so-called one-leg transaction) – in respect of those parts of the payment transaction carried out in the EU. Currently, the conduct of business requirements of the PSD generally only extend to payment services provided within the EEA where both the payer's payment service provider and the payee's payment service provider are, or the sole payment service provider in the payment transaction is, located in the EEA and the transaction is in an EEA currency.

- *New payment services:* since the PSD was adopted, two new types of payment services have emerged, particularly in the area of internet, e-commerce payments. PSD 2 seeks to encompass these new services (which are currently unregulated in a number of Member States) and bring them within the regulatory sphere. Such providers will need to apply for authorisation under the PSD 2 regime:

    - *Payment initiation service:* this is an example of a new service that has evolved in e-commerce. It is defined as "a service to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider". Payment initiation services providers "typically help consumers to make online credit transfers and inform the merchant immediately of the payment initiation, allowing for the immediate dispatch of goods or immediate access to services purchased online" (*European Commission, Payment Services Directive: frequently asked questions*). They establish a "software bridge" between the merchant's website and the online payment platform of the payer's account servicing payment service provider in order to initiate payments on the basis of a credit transfer - without the use of a credit or debit card.

- *Account information service:* this is defined as "an online service to provide consolidated information on one or more payment accounts held by the payment service user with either another payment service provider or with more than one payment service provider". In other words, the user is given an overall view or dashboard of his or her bank and/or other payment accounts.

- *Narrowing of exclusions:* PSD 2 will retain many of the exclusions that currently apply under PSD. However, in certain cases there has been a narrowing of individual exclusions. For instance, the commercial agents exclusion will make it clear that it is only available to an agent that is authorised *via an agreement* to negotiate or conclude the sale or purchase of goods or services on behalf of *only* the payer or *only* the payee (some platforms currently rely on the exclusion where they are acting as agent for both parties). The limited network exclusion (relating to services based on payment instruments used to acquire goods or services within a limited network of service providers or to acquire a limited range of goods or services) will also be tightened up to avoid it being used (or, in the Commission's view, abused) by large networks with high payment volumes or wide ranges of products or services. PSD 2 provides that when the total value of payment transactions executed over the preceding 12 months through a network relying on the exclusion exceeds a certain value (EUR 1,000,000) the payment service provider must notify its relevant competent authority (which will then determine whether the activity does or does not qualify as a limited network).

- *Security of payments:* PSD 2 introduces a number of provisions relating to operational and security risks and authentication. These include:

  - *Incident reporting:* requirements to report any major operational or security incident to the competent authority (and to also notify payment service users if their financial interests are or may be impacted by such incident). The EBA is required, by 13 January 2018, to issue guidelines on the classification of major incidents (including standard notification templates and the procedures for notifying such incidents) and on the criteria competent authorities should take into account in assessing the relevance of a reported incident.

  - *Strong customer authentication:* payment service providers will be required to apply "strong customer authentication" when a payer initiates an electronic payment transaction. Strong customer authentication means "an authentication based on the use of two or more elements categorised as knowledge (something only the user knows)" (e.g. a password or PIN), "possession (something only the user possesses)" (e.g. the card or an authentication code generating device) "and inherence (something the user is)" (e.g. the use of a fingerprint or voice recognition) that are" independent, in that the breach of one does not compromise the reliability of the others, and is designed in such a way as to protect the confidentiality of the authentication data". For electronic remote payment transactions (such as online payments) the payment service provider must apply strong customer authentication that includes elements which "dynamically link" the transaction to a specific amount and specific payee. The EBA is required to develop draft regulatory technical standards specifying, among other things, the requirements of the strong customer authentication requirement and the requirements with which security measures must apply in order to protect the confidentiality and integrity of the payment service user's personalised security credentials. On 8 December 2015, the EBA published a discussion paper on strong customer authentication and secure communication under PSD 2, including draft regulatory technical standards. The discussion paper is open for comment until **8 February 2016**.

- *Passporting:* PSD 2 introduces a more detailed passporting procedure than under PSD, designed to reinforce the investigative and supervisory powers of the host state and ensure better cooperation and information exchange between competent authorities. Host Member States can ask for payment institutions operating with agents and branches to provide regular reports on activities and the payment institution can be asked to set up a central contact point in the host territory. The EBA is required to develop draft regulatory technical standards specifying the framework for cooperation and for the exchange of information between competent authorities. On 8 December 2015, the EBA published a consultation on regulatory technical standards on passporting under PSD 2. This is open for comment until **11 March 2016**.

- *Transitional relief for pre-existing payment institutions:* There will be transitional relief for those payment institutions that are already authorised under PSD as at the date on which the PSD 2 provisions take effect. They will be allowed to continue to provide their services without being required to seek authorisation under PSD 2 until:

    - 13 July 2018 in the case of authorised payment institutions; or

    - 13 January 2019 in the case of small institutions who benefited from the waiver under article 26 of PSD.

    In addition, Member States may allow authorised payment institutions to benefit from an automatic authorisation under PSD 2 if they already have evidence that there is compliance with the prudential requirements set out in Title II of PSD 2.

There are a number of other points of detail which are changing under PSD 2 but which are beyond the scope of a brief overview such as this. Firms which are within the scope of PSD (or will be within the expanded scope of PSD 2) should familiarise themselves with the changes and review and consider the EBA's discussion / consultation papers and draft regulatory technical standards. Existing firms should consider to what extent they will want to take advantage of the transitional provisions beyond 13 January 2018 or whether they will be in a position to obtain automatic PSD 2 authorisation by being able to evidence PSD 2 prudential requirements compliance to their regulator.

14. EU CAPITAL MARKETS UNION – PROPOSED NEW SECURITISATION RULES

On 30 September 2015, the European Commission published its action plan for the European capital markets union, detailing a number of high-level proposals that are designed to improve the effectiveness of EU capital markets. We published a briefing note providing further detail on the most significant of these proposals, which is available here.

Two of the key proposals put forward by the Commission relate to the regulatory treatment of securitisations, addressing the structuring of securitisations and the regulatory capital treatment of holding securitisation positions respectively.

The first proposal is to introduce a new EU regulation (the "**Securitisation Regulation**") which is primarily designed to help investors differentiate between more complex, "opaque" securitisations and those that are simple, transparent and standardised ("**STS securitisations**"). In order to qualify as an STS securitisation, the relevant securitisation must satisfy a large number of criteria, such as being a "true-sale" (rather than synthetic) securitisation and having pre-determined homogenous underlying exposures, rather than having exposures that are actively managed on a discretionary basis. The Commission has emphasised that the STS securitisation label is designed to indicate to investors the process that has been followed in structuring the securitisation, rather than being an indication of the credit quality of the underlying assets. The label is not intended to suggest that investors in securitisations should not carry out their own comprehensive due diligence on any proposed investment. Exposures to STS securitisations will benefit from a more favourable regulatory capital treatment under the new rules.

In addition, the proposed Securitisation Regulation will repeal the piecemeal sectoral rules in legislation such as the Solvency II Delegated Regulation, the CRR or the AIFM Directive relating to due diligence requirements, replacing these with a single set of requirements applying to any investors governed by those regimes. For the first time, UCITS funds investing in securitisations will also be subject to the same specific due diligence requirements.

The Securitisation Regulation will also adopt a new "direct" approach to retention requirements, making EU original lenders, originators or sponsors subject to a direct requirement to hold the retention slice in a securitisation, rather than creating an indirect obligation through potential increased capital requirements for investors in non-compliant securitisations, as at present. However, the Commission intends that the "indirect" approach will continue to apply to investments made by EU institutions in securitisations in respect of which neither the originator nor the sponsor nor the original lender is established in the EU (and therefore would not be directly subject to the Securitisation Regulation). New investor transparency obligations will also apply to EU originators, sponsors and securitisation special purpose entities.

The second proposal is to repeal the existing provisions relating to the regulatory capital treatment of securitisations in the CRR and to replace them with a more risk-sensitive set of rules. The proposed new rules are complex, but in summary, they involve a greater number of distinctions between different types of securitisations (for example, traditional and synthetic securitisations, or securitisations and re-securitisations) and an increased focus on the risks associated with the assets underlying the securitisation. In certain cases, new maximum capital requirements will apply, potentially capping the regulatory capital requirements in connection with certain securitisation positions at a lower level. In addition, there will be a new mandatory hierarchy of methodologies that must be applied when determining regulatory capital requirements for securitisation exposures. The amendments to the CRR will also give effect to the more favourable capital treatment for STS securitisations.

It is intended that the new rules in the Securitisation Regulation would apply to only to issuances of securities made on or after the date on which the new legislation enters into force. In relation to the revised regulatory capital provisions in the CRR, the Commission is proposing a transitional provision whereby firms may elect to apply the pre-amendment rules to securitisation exposures until 31 December 2019. However, any firm that chooses to rely on the transitional would need to notify its regulator by a fixed date (which is yet to specified in the draft legislation) of its intention to do so and would need to apply the existing rules to all outstanding securitisation exposures that it holds on the date that the new rules take effect.

The proposed Securitisation Regulation and the accompanying amendments to the CRR are now in the process of being considered by the European Parliament and Council, although no specific intended timeline for their adoption has yet been announced.

15. EU CENTRAL SECURITIES DEPOSITORIES REGULATION – THE HARMONISATION OF SETTLEMENT CYCLES, DISCIPLINE AND INFRASTRUCTURE

The Regulation on improving securities settlement in the EU and on central securities depositories (Regulation 909/2014), the EU Central Securities Depositories Regulation ("**CSDR**"), came into force on 17 September 2014.

AIM

While the CSDR is detailed and far reaching, its overall goal is to increase the safety and efficiency of securities settlement and settlement infrastructures throughout the EU. It aims to achieve this goal through a number of means, including by:

- harmonising the requirements for the authorisation and supervision of EU central securities depositories ("**CSDs**"), including through the imposition of stricter prudential requirements and common conduct of business rules, and for its recognition of third country CSDs;
- instituting shorter settlement periods through the introduction of a standard securities settlement cycle of T+2 for transactions in transferable securities executed on a regulated market, MTF or OTF (a "**trading venue**");
- establishing a harmonised mandatory securities settlement discipline regime, by (amongst other things) introducing mandatory buy-ins and cash penalties for failed settlement;

- introducing an obligation to represent all transferable securities issued by an EU issuer and admitted to trading or traded on a trading venue in book entry form (i.e. either by being immobilised or dematerialised);

- requiring certain transactions in transferable securities (including financial collateral arrangements) and wherever the issuer is located to be settled in a CSD; and

- creating a single market for CSD services.

TIMETABLE

While the CSDR came into effect on 17 September 2014, it is subject to phased implementation. Consequently, many of its provisions are not yet in force and some will only apply once regulatory and implementing technical standards and delegated acts have been published and when central securities depositories have become authorised or recognised under, and in accordance with, the CSDR. In the case of the mandatory immobilisation/dematerialisation obligation on EU issuers – i.e. the obligation to arrange for their transferable securities (as defined in MiFID II) which are admitted to trading or traded on trading venues to be represented in book-entry form on an immobilised basis or issued in dematerialised form - this will apply from **1 January 2023** to transferable securities issued after that date and from **1 January 2025** to <u>all</u> transferable securities (although H.M. Treasury considers there may be a case for bringing this forward in the UK - see below).

HMT CONSULTATION: CHANGES TO FSMA AND THE UNCERTIFICATED SECURITIES REGULATIONS 2001

Although the CSDR is directly applicable in Member States, certain amendments are nonetheless required to UK legislation to facilitate implementation. When the CSDR first came into effect in 2014, the UK introduced the Central Securities Depositories Regulations 2014 which designated the competent authorities relevant to the provisions of the CSDR active at that time (i.e. broadly, the FCA as the competent authority for the supervision of trading venues, the PRA as the competent authority for the authorisation and supervision of CSDs that are credit institutions and the Bank of England as the competent authority for the authorisation and supervision of other types of CSD and the oversight of securities settlement systems). However, further changes will be required as and when the Level 2 implementing measures under CSDR come into force – i.e. the Regulation's implementing technical standards, regulatory technical standards and delegated acts. These are expected to be agreed and published in early 2016.

In anticipation of these forthcoming Level 2 measures, on 8 December 2015, H.M. Treasury issued a consultation on changes to UK legislation. The government acknowledges that the consultation is broad in scope, but, among other things and in outline, it addresses the following:

- amendments to the UK Central Securities Depositories Regulations 2014 to provide for some additional designations – the FCA will be the competent authority for supervising investment firms for CSDR purposes (to the extent that investment firms have functions under the CSDRs) and the Bank of England will be the competent authority for enforcing the requirements of CSDR related to settlement internalisers and CCPs;

- amendments to the UK Central Securities Depositories Regulations 2014 to make provisions in relation to settlement internalisers – i.e. institutions (including those authorised under the CRD IV Directive or MiFID II) which execute transfer orders on behalf of clients or on their own account other than through a securities settlement system. These will include, in practice, custodians and large brokers. Under the CSDR, settlement internalisers are required to report to their competent authority on a quarterly basis the aggregated volume and value of all securities transactions that they settle outside securities settlement systems. H.M. Treasury proposes to give the Bank of England various powers in support of its role as the designated competent authority in this regard;

- changes to FSMA to cater for the fact that the RTS and ITS will determine how the authorisation process for CSDs will apply and to add a new recognition category. These changes will include an amendment to Part 18 FSMA to give CSDs authorised under the CSDR exempt person status (as "recognised central securities depositories"). This means that they will be exempt from the general prohibition in section 19 FSMA as regards any regulated activity which is carried on for the purposes of, or in connection with, "core" CSD services listed in Section A of the Annex to the CSDR which the CSD is authorised to provide or are covered by its recognition, together with any non-banking-type ancillary services listed in Section B of the Annex, which the CSD is authorised to provide or which have been notified to its regulator or covered by its recognition. Recognised CSDs will be distinguished from recognised clearing houses (RCHs) and it will be clarified that CSD services are not "clearing services" for the purposes of FSMA. If the CSD wishes to provide banking-type ancillary activities (as listed in Section C of the Annex to the CSDR) the exemption under FSMA would not cover these and the CSD would have to apply for permission to carry on these activities as an authorised person. The government is currently considering whether the CSDR permits a CSD to provide MiFID investment services or activities in addition to the services listed in Section A or B of the Annex to CSDR;

- amendments to the Uncertificated Securities Regulations 2001 to remove the current approval regime for a person wishing to become an Operator of a "relevant system" (i.e. a computer-based system and procedures enabling title to units of a security to be evidenced and transferred without a written instrument, and which facilitates supplementary and incidental matters) and to replace it with automatic permission for CSDs authorised or recognised under CSDR. The definition of Operator will be amended to mean a person operating or proposing to operate a relevant system who is a recognised CSD, EEA CSD or third country CSD within the meanings of section 285(1)(e), (f) and (g) of FSMA (as to be amended).

The H.M. Treasury consultation includes draft Uncertificated Securities (Amendment) Regulations 2016 and draft Central Securities Depositories Regulations 2016. The consultation is open until **4 February 2016**.

DEMATERIALISATION / IMMOBILISATION

The H.M. Treasury consultation does not address the obligation under the CSDR on EU issuers of transferable securities admitted to trading or traded on trading venues to arrange for those securities to be represented in book-entry form on an immobilised basis or issued in dematerialised form. This "compulsory dematerialisation" issue will be addressed in a separate consultation from the Department of Business, Innovation and Skills which is expected in due course. In the meantime, H.M. Treasury notes that, while Articles 3(1) and 76(2) of the CSDR set a deadline of 1 January 2023 for dematerialisation of new issues of transferable securities and 1 January 2025 for all transferable securities, "there may be a case for bringing dematerialisation forward" (although it does not say what that is) and that, as such, BIS will consult on options for implementing the requirements.

16. DTRs AND DISCLOSURE REQUIREMENTS: RECENT CHANGES

A number of changes were made at the end of November 2015 to the Disclosure and Transparency Rules (the "**DTRs**") as a result of the EU Directive amending the Transparency Directive (the "**Amending Directive**").

While the amendments do not amount to a material overhaul of the provisions, there are some significant points of detail.

The UK regime had previously been "super-equivalent" to the Transparency Directive in that the DTRs have required disclosure of contracts for difference and other financial instruments "with a similar economic effect" since June 2009. The Amending Directive effectively extended this regime across the EU. As a result, there have been no major changes to DTR5 in this respect. There are a few points to note however:

- The FCA has conformed to the EU model by providing that the disclosure of financial instruments is limited only to those relating to <u>already issued</u> shares. Previously, DTR5 extended to rights in respect of shares <u>not already issued</u>, e.g. convertible bonds or nil paid rights in rights issues. If a company has historically made disclosures in respect of financial instruments relating to as yet unissued shares, a corrective disclosure may need to be made.

- Where voting rights relating to financial instruments have already been notified under the DTRs, these must be notified again when the person acquires the underlying shares.

- There is now a requirement for a notification to (1) include a breakdown by type of financial instruments held and (2) distinguish between the financial instruments which confer a right to physical settlement and the financial instruments which confer a right to a cash settlement.

- The FCA has deleted some of DTR 5 which was specifically included to cater for the super-equivalent UK regime. Instead, DTR 5 now incorporates some of the relevant provisions from the Amending Directive so the two are more closely aligned.

- There is no longer a standalone exemption for client-serving intermediaries that is distinct from the existing market maker and trading book exemptions.

    - This standalone exemption was previously an exemption for instruments having a similar economic effect to qualifying financial instruments where the holder was acting in a client-serving capacity, for example CfD positions taken as a result of filling a client order or to hedge a client order. Such a holder needed to be acting as a client-serving intermediary and would have needed (amongst other things) to have certified in writing to the FCA that it considered itself to qualify for client-serving intermediary status.

    - Acting in a "client-serving capacity" meant fulfilling orders received from clients otherwise than on a proprietary basis, responding to a client's request to trade otherwise than on a proprietary basis or hedging positions arising out of such dealings.

    - Under the amended DTRs, transactions executed in a client-serving capacity will now have to rely on the existing trading book exemption, rather than benefitting from a standalone exemption. As the trading book exemption is a partial exemption (capped at 5%), financial instruments with similar economic effect held in a client-serving capacity will need to be aggregated with the holder's position in other financial instruments of the same issuer. If the aggregated holding reaches or crosses the 5% trading book exemption threshold, the holder will have to disclose that holding.

- The changes clarify that the disclosure requirements are the same for all investment managers (including those in the EEA, the US or elsewhere). All investment managers will disclose at the 5%, 10% and above thresholds (based on the qualified exemption). This change should not have an adverse impact on the market as both EEA and US investment managers currently disclose at the 5% threshold without any obvious problems.

- Stock lending agreements are now subject to the same notification requirements as all other holdings within the scope of the DTRs. Previously, where a stock lending arrangement included a right of recall, the stock loan did not constitute a "disposal" and therefore did not require disclosure by the lender. Borrowed shares under a stock lending agreement were also exempt from the disclosure requirements (and so a borrower would not have to disclose) provided they were on-lent or otherwise disposed of by the borrower by close of business on the next trading day, and the borrower did not declare any intention of exercising (and did not exercise) the associated voting rights. Now, a loan of relevant shares under a stock lending transaction will need to be disclosed by both the lender (as a disposal) and the borrower (as an acquisition) at the applicable thresholds set out in the DTRs. Any entity which actively lends or borrows shares will therefore need to refer to the notification requirements and thresholds set out in DTR 5 and notify at the applicable thresholds. These will be 5%, 10% and above for investment managers which fall within the investment manager exemption in DTR 5.1.5R. Where an entity cannot rely on the investment manager exemption the thresholds will be lower and narrower - i.e. 3%, 4%, 5%, 6%, 7%, 8%, 9%, 10% and each 1% threshold thereafter up to 100%.

- The definition of "issuer" has been amended with respect to depositary receipts to clarify that the issuer is the entity with respect to whom the underlying securities relate, rather than any other depositary entity that issues the depositary receipts. There will still be no DTR requirement to disclose interests in depositary receipts if the underlying shares are not admitted to trading on a regulated market.

Firms should note the impact of the above changes and in particular those which relate to investment managers and those which now require the disclosure of stock borrowing agreements by both borrower and lender.

17. FURTHER CHANGES TO THE FCA COMPLAINTS HANDLING RULES

By way of reminder, the complaints sourcebook ("**DISP**") will be subject to a number of amendments taking effect on **30 June 2016**. These will be the last set of changes to give effect to a range of improvements to the complaints handling procedures (including implementation of the Alternative Dispute Resolution Directive ("**ADR Directive**")) on which the FCA first consulted back in December 2014 and which were finalised in July 2015.

The scope and application of DISP will remain the same (subject to an expansion in scope to include persons which are subject to the Mortgage Credit Directive and which are not firms on 21 March 2016).

A number of the changes consulted upon came into effect on 9 July 2015 (to implement the ADR Directive) and the rules on call charges (capping them to a maximum "basic rate") came into effect on 26 October 2015. However, the changes summarised below were postponed to take effect on 30 June 2016:

- *Complaints handled within three business days:* The "next day business rule" will be extended to three business days:
  - The "*third business day rule*": DISP 1.5 currently provides that the rules (and the eight week formal process) will not apply to a complaint that is resolved by a respondent by close of business on the next following day. Once amended, the complaints time limit rules and the complaints forwarding rules will not apply to complaints resolved by close of business on the **third business day** following the day on which it is received. The FCA says that it takes "by close of business" to mean by the end of the ordinary business hours within which a specific firm operates, and this is likely to vary depending on the size and resources of the firm. However, firms will in future have to report the number of complaints handled within the three business days.
  - "*Summary resolution communication*": If a complaint has been resolved satisfactorily by the close of the third business day, then the respondent firm will no longer have to send a final response letter as now – instead respondent firms will be required to send a "summary resolution communication" (in line with the ADR Directive). This summary resolution communication must:
    - Refer to the fact that the complainant has made a complaint and inform the complainant that the firm now considers the complaint to be resolved;
    - Make the complainant aware that if he subsequently decides he is dissatisfied with the resolution of the complaint, they may be able to refer it to FOS;
    - Indicate whether or not the respondent consents to waive the relevant time limits in DISP 2.8.2R or DISP 2.8.7R (Was the complaint referred to FOS in time?); and

        - Provide the address of the FOS website and refer to the availability of further information on that website - this information should be set out clearly, comprehensibly, in an easily accessible way and prominently.

    - *Reporting of complaints settled within three business days:* **Firms will have to report all complaints to the FCA** (including those settled within the three business day period):

        - Under the current rules, FCA-regulated firms within the scope of DISP are required to report to the FCA the number of complaints they receive, apart from complaints resolved informally by the end of the next business day

        - From 30 June 2016, DISP will provide that all complaints must be reported to the FCA (including those that are resolved by the end of the third business day)

        - All reporting of complaints will have to be made on a new complaints return form (see below).

- *Publication of complaints data by the FCA:*

    - From 30 June 2016 there will be amended rules governing the publication of complaints data by the FCA.

    - The FCA will publish complaints data about the financial services industry as a whole (and, in certain cases, also firm-level complaints data (for those firms that are required to publish a complaints data summary or the total number of complaints)).

    - For firms reporting 500 or more complaints (or 1000 or more complaints in the case of firms with permission to carry on only credit-related regulated activities or operating an electronic system in relation to lending with revenue that is less than or equal to £5,000,000 a year) in the relevant reporting period, the FCA will publish the firm-level complaints data and information providing context to the complaints data reported to it. It will do this either after the firm provides the appropriate consent in the complaints data reports or after the FCA receives an email from the firm confirming that the complaints data summary accurately reflects the report submitted to the FCA, that the summary has been published and where it has been published.

- *New complaints return forms:*

    - From 30 June 2016 there will be new complaints return forms. However, other aspects of complaints reporting will remain the same - so reporting will still be twice a year and firms will continue to use the GABRIEL electronic reporting system.

    - There will in fact be two different versions of the complaints return form: a detailed form will need to be submitted by any firm which has received 500 or more complaints during the reporting period; a shorter and more simplified version will be available for those firms which have received fewer than 500 complaints in the reporting period.

    - The complaints return form will (amongst other things):

        - include a new list of categories of complaint, set against product/service groupings

        - add new metrics, relating to the number of sales, policies and accounts, depending on the product/service grouping

    - Where a firm receives fewer than 500 complaints in a reporting period, it will be permitted to submit a simplified version of the table;

- The complaints return form should be submitted via GABRIEL as before.

18. FCA ASSET MANAGEMENT REVIEW

On 18 November 2015, the FCA published the terms of reference for its asset management market study (MS15/2.1), which will be undertaken during 2016 under its competition powers. The main aim of the study is to understand how competition is working within the market for asset management products and to determine whether the FCA should introduce market-wide and/or firm-specific remedies for any identified competition failings. Alternatively, the FCA has indicated that it may also make a market investigation reference to the UK Competition and Markets Authority if it considers that this is appropriate following the outcome of the review.

In general, the study will cover a wide range of market participants, including consumers, product providers, distributors, administrative or ancillary service providers and third party products and services. However, the terms of reference also set out a number of specific areas or categories of market participants which are, at least at the present time, **outside the scope of the review**. These include the following:

- private equity funds;
- third party research and execution services;
- contracts for difference providers;
- stockbrokers;
- retail advisers; and
- sovereign wealth funds.

The three main topics that will be explored in the study are:

1. how asset managers compete to deliver value;
2. whether asset managers are willing and able to control costs and quality along the value chain; and
3. the effect of investment consultants and other advisers on competition for institutional investment management.

The terms of reference indicate that the FCA will use its statutory information gathering powers to obtain the relevant data from FCA-regulated firms and may also request data to be provided on a voluntary basis from firms and individuals that are not subject to FCA regulation. The data gathering process will include a number of roundtable and bilateral meetings with stakeholders to discuss the topics raised in the terms of reference. Firms that are within scope of the study may therefore receive data requests and/or invitations to such meetings in due course.

The FCA intends to publish an interim report in the summer of 2016, at which time it may indicate that it is prioritising certain issues and may narrow the scope of the study accordingly. The final report is expected to follow in early 2017.

19. EXTENSION OF THE UK SENIOR MANAGERS AND CERTIFICATION REGIME

The Senior Managers and Certification Regime ("**SMCR**") was one of the recommendations stemming from the Parliamentary Commission on Banking Standards ("**PCBS**"), which was set up to improve standards in the UK banking industry. One of the key conclusions of the PCBS was that the existing UK Approved Persons Regime ("**APR**") was overly complex and had resulted in insufficient personal responsibility for senior individuals within banks. The PCBS proposed that the SMCR should be introduced to replace the discredited APR and to ensure a much clearer allocation of individual responsibilities to banks' senior managers, reinforced by a wider regime for all other bank staff whose actions or behaviour could seriously harm the bank, its reputation or its customers.

The current SMCR will apply to banks, building societies, credit unions, PRA-designated investment firms and UK branches of non-UK banks from 7 March 2016. In addition, a separate regime (the Senior Insurance Managers Regime) will apply to UK insurers and UK branches of non-UK insurers, with elements of that regime entering into force on 1 January 2016 (to implement Solvency II requirements, where applicable) and the remainder entering into force on 7 March 2016.

By way of summary, the key elements of the SMCR are as follows:

- *Senior managers regime:* This will apply to those individuals who are performing "senior management functions" ("**SMFs**"). These individuals will require pre-approval from the regulator, although firms will be obliged to ensure that they have procedures in place to assess the fitness and proprietary of such individuals before any application for regulatory approval is made and on an annual basis thereafter. Applications for regulatory approval of SMFs must be accompanied by a statement of responsibilities setting out the areas of the firm's business for which the relevant individual is responsible. In addition, the firm will need to provide the regulator with a management responsibilities map indicating how all responsibilities across the firm have been allocated to different senior managers. This is designed to ensure that there are no "responsibility gaps" where it is unclear which SMF has responsibility for a particular operational area.

- *Certification regime:* This will apply to those individuals who are not performing SMFs within the firm, but who are performing a function which the regulator has determined could result in significant harm to the firm or any of its customers. Such individuals will not need regulatory pre-approval to carry on the relevant function, but the firm must instead certify that the individual is fit and proper both when first appointing the individual to the role and annually thereafter.

- *Rules of conduct:* The rules of conduct will apply to all individuals holding SMFs and all certified persons, as well as all other employees within the firm, except those who perform an ancillary role that would essentially be the same in a non-financial services firm (for example, receptionists, security guards or cleaning staff).

In June 2015, the Fair and Effective Markets Review ("**FEMR**") published its final report setting out the steps that it considered should be taken to restore confidence in the wholesale fixed income, currency and commodities ("**FICC**") markets in the UK. The FEMR concluded that there was a case for the extension of the SMCR to cover at least other participants in the FICC markets, noting that entities other than banks had been engaged in serious misconduct (such as the involvement of interdealer brokers in the manipulation of LIBOR, for example) and that non-banks were increasingly becoming more important players in the FICC markets.

Subsequently, on 15 October 2015, H.M. Treasury published proposals that would extend the scope of the SMCR to all UK authorised firms from 2018, and not only those active in the FICC markets. Those proposals have been incorporated into the Bank of England and Financial Services Bill which is currently being debated in Parliament. The initial proposals indicate that the extended SMCR will have the same key features as the current banking SMCR, but will be applied in a "proportionate manner", although the precise implications of this will not be apparent until the final legislation and regulatory rules are settled.

In addition to the proposed extension of the SMCR, H.M. Treasury's policy paper also proposes removing the "reverse burden of proof" whereby, following the contravention of regulatory requirements in the part of the business for which a senior manager was responsible, (s)he would have been liable if (s)he could not demonstrate to the regulator that (s)he took all reasonable steps to prevent that breach occurring or continuing. Instead, it will be necessary for the regulator to demonstrate that the relevant senior manager failed to take the steps that it was reasonable to expect him or her to take in the circumstances. The Treasury is also proposing to remove the obligation on firms that are subject to the SMCR to report to the regulators any breach of the rules of conduct by employees, recognising that such an obligation would have been costly and disproportionate.

Firms should pay close attention to developments in relation to the extended SMCR in the coming year, as the new regime will have a significant impact on their governance arrangements and operations from 2018. In light of the important implications for all FCA-authorised persons, firms should also consider responding to consultations where appropriate in order to ensure that the proposals are shaped in a proportionate and practical manner.

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